

SURVEY OF INTERNATIONAL ECONOMICS

For
Post-Graduate Classes

(IN QUESTIONS & ANSWERS)

By
Prof. MALHOTRA



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INTRODUCTION

NEED FOR A SEPARATE THEORY OF INTERNATIONAL TRADE

Q. "International trade is only one aspect of interlocal and inter-regional trade." Discuss.

"The theory of trade between nations differs from the theory of trade with in a nation." Explain.

Ans. "International trade is treated as a distinct subject because of tradition, because of the urgent and important problems presented by international economic questions in the real world, because it follows different laws from domestic trade, and because its study illuminates and enriches an understanding of Economics as a whole"¹.

International Trade

Interregional

The term trade is commonly understood to mean exchange of goods among peoples. If National markets also differ more widely than regional markets on grounds of tastes, customs and habits. But international trade can also be distinguished in kind from domestic trade. It runs between different political units, each with a sovereign government responsible for the well-being of the unit. This accounts for difference in national economic policies—in monetary, exchange, trade, wage and similar areas.

Inter-regional and international trade are both concerned with problems of overcoming space. The relative abundance of records on the trade of nations, as contrasted with that of regions, makes the former (international trade) a better subject for the study of the growth and decay of complex economic, political and social entities.²

International Trade

The term trade is commonly understood to mean exchange of goods among people. It comprehends every species of exchange. Trade may be internal or external. Internal or domestic trade refers to transaction limited with in the geographical boundaries of a nation or a region. It is called inter-regional or home trade. International trade is trade among

1. Charles, P. Kindleberges, International Economics (Homewood, Richard D. Irwin, 1968, p. 1)

2. Charles, P. Kindleberges ; International Economics (Homewood, Richard D Irwin, 1968, pp. 11—12)

different countries across the political frontiers. intra-regional trade is foreign trade.

The economic reason of international trade is the same as that of the domestic trade. *i.e.*, to raise the standard of living of the masses in a country. The fundamental basis of international trade is that : all countries cannot produce all the things equally well and cheaply ; unequal distribution of natural resources exists ; all available factors of production cannot be substituted perfectly and the lack of mobility of labour is a fact. International trade is the result of geographical specialisation as in the trade between two regions, as jute and cotton in Bengal and Bombay respectively. Difference between them is one of degree and not of kind.

International Trade distinguished from Inter-regional Trade

The following considerations point to the distinction between inter-regional and international trade and consequently lead to the need for a separate theory of international trade :

1. Immobility of Factors of Production :—Ricardo advocates the case for a separate theory of international trade on the ground that the factors of production are immobile between nations whereas they are free to move within the nations. Capital and labour are mobile within a country, they believed, but not internationally. Even land can be regarded as mobile within in a country. Consequently the returns to factors tended to equality within, but not between countries. But this assertion of the classicists is not fully accepted. There is some mobility of factors internationally as we can and do speak of European market for labour. On the other hand, there is considerable degree of immobility within countries.

It may be all right to say that there is a difference of degree in factor mobility inter-regionally and internationally and that in the usual case people will migrate within their own country more readily than they will migrate abroad. Identity of language, customs and traditions cannot be assumed between parts of a country, but they are more likely that between countries.

To the extent that there are differences in factor mobility and equality of factor returns, international trade will follow different laws as compared with inter-regional trade.

2. Separate Markets :—

Markets are separated by language, custom, usage, habit, taste, and a host of other causes of difference. Standards differ. Some goods are designed in inches, feet, pounds and short tons ; some in metric measurements. Even within the non-metric systems, the Americans reckon oil in barrels per day, the British in short tons per year. Export and import trade must get outside of the culture of the domestic market to become acquainted with different goods, described in different words, using different measurements, bought and sought in different terms, for different currency units.

3. Politically Different Units :—

The cohesion and solidarity is greater among people belonging to the same nation than among people belonging to different nations. This cohesion of the national group helps to explain national differences in tastes and customs which are dividers of national markets. It also explains a degree of exclusiveness shared by members of a nation against outsiders. Policies are directed with the narrow end of satisfying the groups within the nation. The task of international economics is to find, if it can a basis for economic relationships which will be satisfactory among the various components of a peaceful world.

4. Different National Policies :—

National rules, regulations and policies relating to taxation, labour standards, health sanitation, factory organization, social insurance, trade unions, education, public utilities are more or less uniform for different regions of a country whereas these considerations differ in different countries. This, of course, does not mean that rules, regulations and policies relating to these matters are completely uniform in the different regions of a country. However, they are likely to be greater between the countries than among the countries. Thus the difference is only of degree and not of kind.

5. Different National Groups :—

The concept of nationalism promotes the 'we' feeling among the people against 'they'. The group is unified against other groups. In the 19th century nationalism had not acquired this sharp tone. The government could be held responsible to the world at large. Members of upper middle class felt greater unanimity and sense of identity with their counterparts in different countries than they felt with the working class of their own country. However, this is not possible. Kindleberger conveys the point forcefully when he says, "The difference between inter-regional and inter-national trade is that trade between regions is trade among the same group, whereas trade between countries runs between different cohesive units. Friedrich List, a hundred years ago expressed it, "Domestic trade is among us, international trade is between us and them."¹

6. Different-Moneys :—

At the superficial level the difference between inter-regional and international trade would seem to be in the fact that the latter involves the use of different-moneys. A rupee is accepted in Calcutta and Bombay, but a Swiss franc must be converted into rupee if it is to command the purchase. However, the real fact is not the existence of different moneys but the possibility of change in their relative value. The risk of a change in the value of foreign currencies as balance tends to make people keep their capital at home. On the other hand, after a long period of stable exchange rates, capital becomes more venturesome in moving over the world,

1. Charles. P. Kindleberger, International Economics (Homewood Richard D. Irwin Inc. 1968, p. 9)

and international mobility approaches that which obtains within countries. As such the fact, that different countries follow different exchange policies, distinguishes international from domestic trade.

Specific Problems.

Problems of money and banking, wages and prices etc. are more difficult of solution in an international than in a national context. In money and banking, the more difficult character of international problems is self-evident. Foreign exchange crises are chronic in some countries. In the United States there is doubt as to what is the right balance-of-payment concept to use. All these testify to the unsettled character of international payments as contrasted with those within a country.

Inter-regional wage difficulties arise, but are of a different order of magnitude from those in international trade. Uniformity of wages throughout the country may be demanded by trade unionists, but the prospect of uniformity at the international level is looked with disfavour and is unlikely for a long time.

Inter-regional problems of price arise with more frequency. Internationally, however, the price seems seldom to be right. Most of countries are worried about their adverse terms of trade.

This is not a conclusive demonstration. There is, however, something of a presumption that economic problems are different, and more difficult of solution, when they run between countries than when lie within the jurisdiction of a single government.

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- II. Sneider D.A. : Introduction to International Economics.
- III. Harry G. Johnson : International Trade and Economic Growth.

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THE PURE THEORY OF INTERNATIONAL TRADE : SUPPLY

Q. "The theory of comparative costs has stood up much better than other parts of the old classical doctrine". Discuss.

Or

What, according to you, is the rationale of international exchange of goods and services ?

Or

State the classical theory of international trade. What are the main criticisms advanced against it ?

Ans. Appreciation of past theory is essential for the proper understanding of the modern approach. The modern version has evolved out of some crude theories of past. Some of these crude theories of past are discussed below.

Mercantilists Approach to Trade.

It took various terms but essentially it was a belief that national power depended upon national economic wealth. Wealth was equated at this time the possession of precious metals, and a nation aspiring to greatness would try to amass as large as possible a stock of gold and silver. Since a country's stock of bullion increased when exports exceeded imports, a corollary of Mercantilism was the attempt to build up a surplus of exports over imports. This excess was accordingly referred to by the Mercantilists as a favourable balance of trade. Little account was taken of the fact that it was impossible for all countries simultaneously to achieve a favourable balance of trade. To those accepting Mercantilistic principles, trade was a means of national political aggrandizement. Its object was power rather than plenty. Mercantilist ideas were never universally accepted and economic policy measures associated with them were often enforced only half-heartedly. But until well into the 18th century, they were the ideas which influenced the attitudes of most statesmen and economists towards overseas trade.

Hume and Adam Smith.

The growing criticism of mercantilistic doctrine was sharpened in the middle 18th century by David Hume who, in his political discourses in 1762, argued that the constant pursuit of a favourable balance of trade was not only foolish but also certain to fail. Hume argued that if a country's exports increased more than its imports, the resulting inflow of gold would

itself automatically lead to an increase in the domestic money supply. In accordance with the quantity theory of money a raising of the domestic prices will follow. On the other hand, abroad, the out flow of gold to the surplus country and the consequent reduction in money supply would cause a fall in prices. The raising of the surplus country's domestic prices and the lowering of the deficit country's prices would tend to bring about a fall in the surplus country's exports and an increase in its imports – thus automatically correcting the original imbalance. Thus Hume claimed to show that a given free market in Britain and internal price flexibility, any attempt by a country to build up a long-term favourable balance of trade was foredoomed to failure. Mercantilist policies carried the seeds of their destruction.

Smith.

Hume's approach to the effect of gold movements upon prices and the balance of trade was naive in the extreme, but to Mercantilistic contemporaries was a searching challenge. An even more significant challenge was to come in 1776 with the publication of Adam Smith's 'Wealth of Nations'. Smith applied his famous principle of division of labour to specialisation among countries. He was critical of all measures preventing specialisation, arguing that just as attempts at self-sufficiency by individuals or households resulted in a loss of advantage of specialisation, so also did such attempts among countries. Adam Smith argued so far from creating wealth and adding to national prosperity, policies for self-sufficiency resulted in a net reduction in prosperity and human welfare. Similar to the advantages of specialisation within a country he went on to show how similar gains could be derived from division of labour among nations.✓

The corollary of Smith's reasoning was that impediments to free trade were undesirable and should be abolished. Hume and Smith between them provided the intellectual justification for those anxious to see greater freedom of trade between nations. But this did not mean that victory for free trade was secured either in the realm of ideas or in practical policy-making. And it has never been achieved. Adam Smith demonstrated that two countries would gain from specialisation when one was more efficient than the other at producing product X but it was left to Ricardo to show that there might be gain even when one country was better than its partner at producing both products. This was the famous principle of comparative cost advantage.✓

THE THEORY OF COMPARATIVE ADVANTAGE

Q. Discuss the theory of comparative costs in the context of more than two commodities in a money economy.

Or

Q. To what extent is the validity of the Ricardian theory of comparative costs dependent upon the assumption (a) that labour is the only factor of production, (b) that costs of production within each country are constant?

Or

Q. Critically examine Ricardo's contribution to the theory of international trade.

Ans. Adam Smith propounded the theory of absolute advantages. It could be summed up in this way : "It was far better for a nation to import goods which could be produced abroad more efficiently in terms of real resources than to manufacture them itself." Smith's emphasis on absolute advantages is clear and certain. It also implies that production conditions differ between countries and also within countries. ✓

Ricardo elaborated upon this implication and came out with his famous theory of Comparative Advantages. This could be briefly stated in following words : "So long as differences exist in the relative efficiencies of production of the different goods in two countries, trade can take place to the mutual advantage of both countries." Rich country must have an absolute which is relatively greater than its other advantages; and the poor country will correspondingly have an absolute disadvantage which is relatively less than its other disadvantages. ✓

Ricardo's emphasis on comparative advantage is clearly distinguishable from Smith's emphasis on absolute advantage. We can visualize four cases assuming the usual two goods and two countries model.

Case A. Absolute Advantage in One Country

	America	Australia
F	20	20
S	10	5

The above table illustrates the production possibilities of the two countries. These outputs are alternatives for equal resource inputs which Ricardo regarded as labour time units. Thus, if America uses 1 unit of factor input, it can produce either 20 units of food or 10 units of steel. In this example, both America and Australia are equally efficient at producing food, but America is more efficient at producing steel. Australia has on the other hand, no absolute advantages, but has an absolute disadvantage in steel production.

Trade will take place because Australia will concentrate on food production because she has a comparative advantage in this type of activity. She is worse at producing steel compared with America, than she is at producing food compared with America.

If no trade takes place and no specialisation occurs, world output would be 20 Food and $7\frac{1}{2}$ Steel. However, after trade (specialisation) world output is 10 S (America) and 20 Food (Australia). Thus there has

been an increase of world output (per unit of factor for each country) by $2\frac{1}{2}$ Steel units.

Gain distribution will depend upon demand factors. If demand conditions are such that the final F : S rate of exchange settles down near the 10 F and 5 S end of the range, Australia will gain most from the trade. If it settles down closer to the other end of the range, 10 Food and $2\frac{1}{2}$ Steel, America will gain most.

Case B. Absolute Advantage in both countries.

	America	Australia
F	20	25
S	10	5

In this example Australia and America both possess absolute advantage in Food and Steel respectively. This is the usual Smithian case. Without trade, world output is $22\frac{1}{2}$ Food and $7\frac{1}{2}$ Steel. After trade, world output of Food increases to 25 Food and 10 Steel. The increase of world output (per unit of factor input for each country) is by $2\frac{1}{2}$ Food and $2\frac{1}{2}$ units of Steel.

Case C. Absolute Advantage of one country in both goods, but with a comparative advantage in one.

Suppose the production possibilities are as below :

	America	Australia
F	20	10
S	10	3

Trade will take place because America has a comparative advantage in Steel production *i.e.* America is better at being better in steel production than she is at being better in food production.

Australia is worse at everything relative to America, but is less worse at producing food than she is at producing at Steel. She will concentrate on food production.

Without specialisation, world output (per unit of factor input for each country) is 15 Food and $6\frac{1}{2}$ Steel, but after specialisation becomes 10 Food and 10 Steel. Again the distribution of gains will depend upon demand factors, the rate of exchange lying somewhere between 10 Food for at least 3 Steel but less than 5 Steel.

Case D. Absolute advantage of one country in both goods, but with no comparative advantages in either.

	America	Australia
F	20	10
S	10	5

No trade results. Neither America nor Australia would gain anything by specialisation in either field of production. In other words, comparative advantage fails to arise.

Thus, the necessary and the sufficient condition for trade to take place and be advantageous for the countries engaging in it is that a comparative advantage must occur in the production of one of the goods. The law of comparative advantage could be stated thus: A country will concentrate its production on those things in which it has the greatest relative advantage over other countries and will get from abroad those things in the production of which it has the least relative advantage.

Ricardo was concerned only with two countries—two commodities with one factor-input (labour time). This input was more efficient in one country than in another country with the result that wages would tend to be higher in the more efficient country. Labour movements will take place and would equate wages in both countries. This possibility of ironing out disparity in wages is denied by Ricardo. He argued that factors of production though not completely immobile, were exceedingly immobile between countries as compared with movements within a country. Whereas rates of return to productive factors will tend to equality between the regions of a country, this would not occur between nations simply because of factor immobilities.

Criticisms of Ricardo

The following criticisms against Ricardo's theory of comparative advantage are made :—

- (a) He tied his theory of trade to labour costs and to labour costs alone.
- (b) He was concerned only with the supply side. He neglected demand side.
- (c) He did not take account of the effect of transport costs.
- (d) He was concerned with only two countries, two commodities model.

The first two criticisms are serious and potentially damaging. The effect of introducing transport costs and multilateral commodity analysis is simply to modify Ricardian conclusions.

However, the introduction of demand can lead to a reversal of Ricardo's conclusions. In such cases, demand factors play a relatively greater part than the productivity of factors inputs in determining the direction of trade.

Ricardo's theory of value has also been attacked. The tendency on the return to labour to be equal throughout a country was seen by observation to be weak and faltering. Labour is not homogenous. If

there is an increase in the demand for barrels, the wages of Cooper's will rise above those of Smith's, with whom they are not interchangeable. It became recognized that there is not one great class of labour with a single wage but a series of non-competing groups between which the tendency to equalization of wages, in the short run, is weak or non-existent.

A more fundamental objection, however, which would apply even if labour were homogenous and commanded one price in a perfectly competitive market, is that goods are not produced by labour alone but by various combinations of all the factors of production: land, labour, and capital. To compare the labour content of two commodities—say, gasoline and textiles or meat and shoes—gives an erroneous view of relative values. Gasoline production requires far more capital per unit of labour than textiles, and meat output more land than shoes. Variable proportions of factors in the production of different commodities make it impossible to use the labour theory of value, however qualified.

Q. Discuss the modifications introduced to the Haberler's theory of opportunity costs.

Or

Q. How far Haberler has been successful in over-coming the limitations created by Ricardo's labour theory of value?

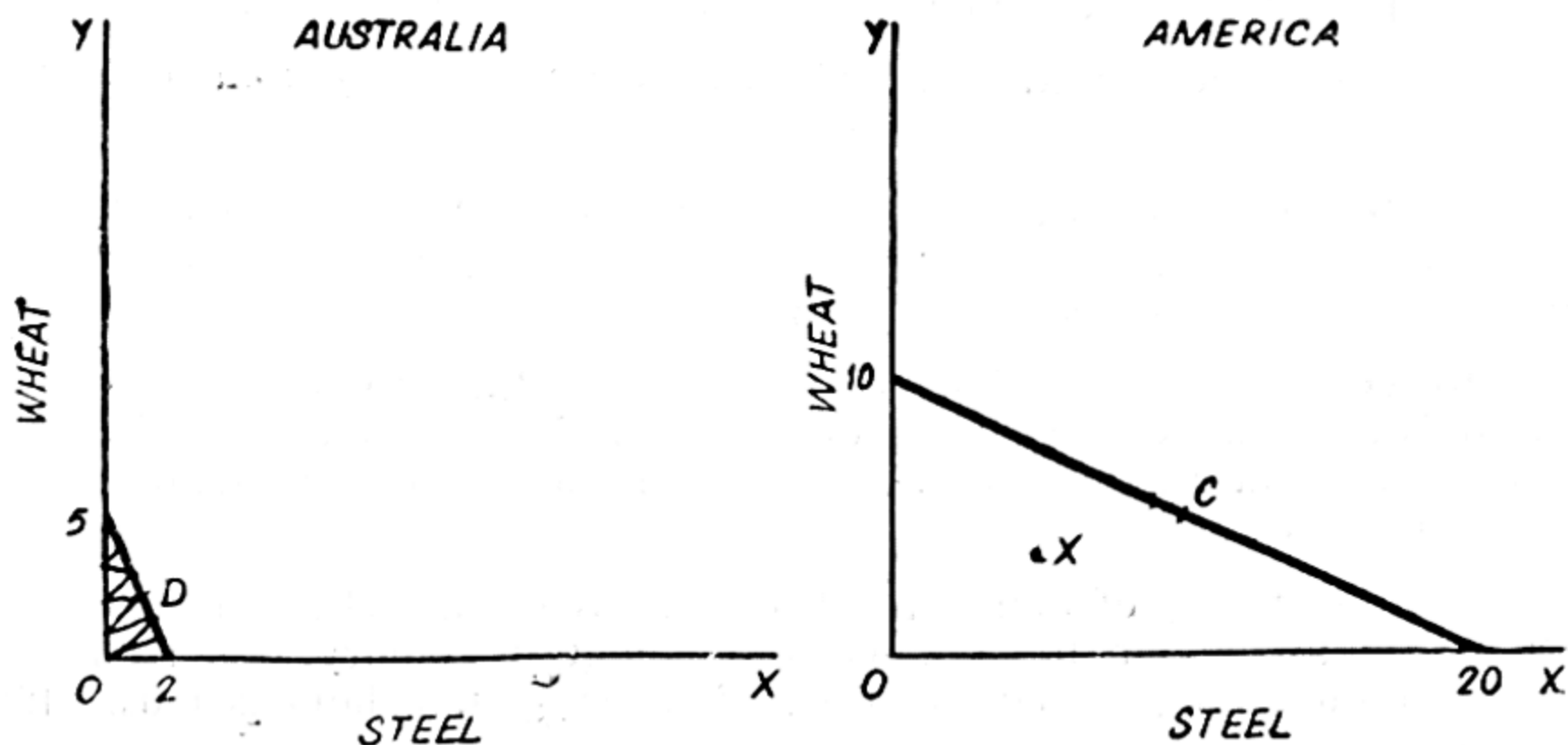
Or

Q. Review critically Harberler's theory of opportunity costs.

HABERLER'S APPROACH

Ans. The theory of opportunity costs a marginal opportunity costs has been developed by Harbeler to overcome the difficulty created by Ricardo's labour theory of value. This idea of opportunity costs in international trade is usually represented by production possibilities curves which show the amount of goods which all factors of production in combination can produce. It is obvious that the emphasis shifts from one factor to all factors.

Suppose we construct a two-commodity two-country model as before.



In the absence of trade, the American production possibilities curve shows that its factors, in combination, could produce either 10 units of wheat or 20 units of steel, or any other combination of wheat and steel represented by any point on its curve.

Any point on the right of the curve is unattainable due to limitation of factor supplies ; similarly, any point within the curve (X) implies that not all of factors are being used.

In Australia's case, the curve shows possibilities of producing either 5 units of wheat or 2 units of steel or any combination along the curve. We have here a case of America having a comparative advantage in steel production and Australian in wheat production. Thus, at any point on America's production possibilities curve, she can produce one more car by giving up a smaller amount of food production than Australia has to give up in order to produce an extra car. Similarly Australia has a comparative advantage in wheat production.

The opportunity cost of wheat is how much steel has to be given up in order to produce an extra unit of wheat ; the opportunity cost of steel is how much wheat has to be given up to produce an extra unit of steel. It makes no difference whether the factors which leave the production of one good to make another are well suited to the new product or not, our definition of opportunity costs is still valid.

Straight line production possibilities curves indicate what is called constant opportunity costs—if any resources shift out wheat production into steel production. America can always produce steel in the constant proportion 1 : 2, no matter what proportion of total resources are shifted.

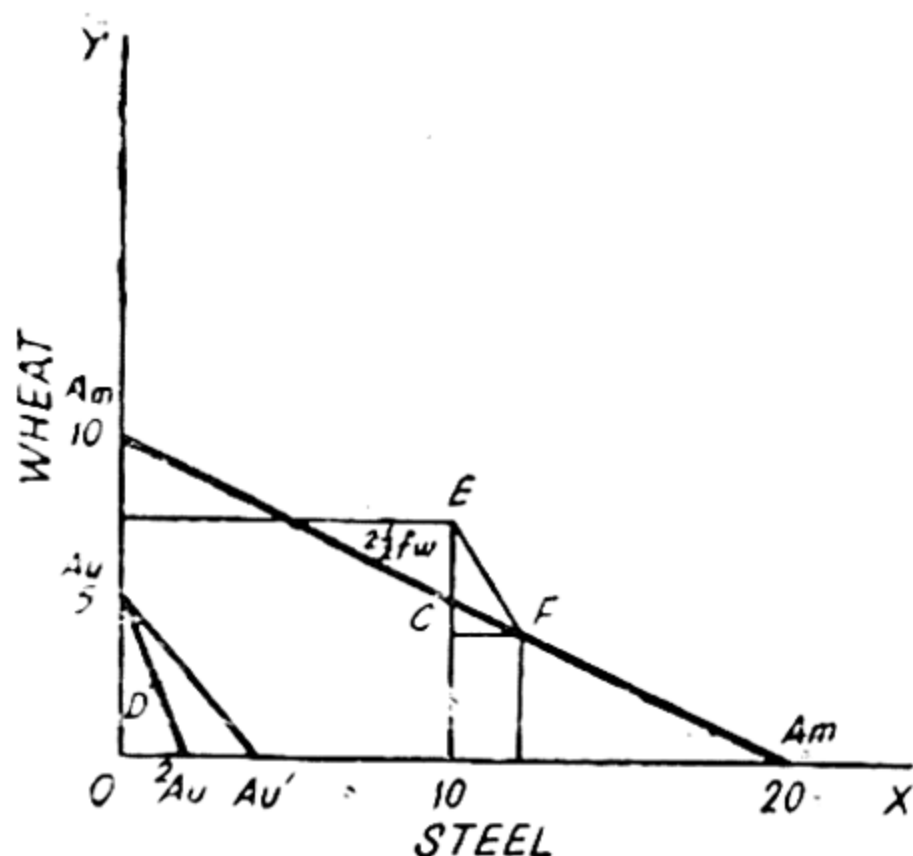
Also it should be noted that with constant opportunity costs, the price ratio domestically will be the same as the opportunity cost ratio (In America's case one unit of wheat will cost twice as much as a unit of steel). Any higher price of steel will shift resources from wheat into steel production ; the supply of wheat will fall and its price rises ; the price of steel will fall as its supply increases until the 1 : 2 price-ratio is restored.

The opportunity cost of a product then is how much of the other goods have to be given up in order to produce one extra unit of that product.

We cannot tell where a country will be on its production possibilities curve before trade (knowledge of domestic demand is required for this) suppose, however, that America is at point C consuming 10 units of steel and 5 units of wheat and Australia is at point D consuming one unit of steel and $2\frac{1}{2}$ units of wheat.

Now superimpose the two production possibilities curves on each other and suppose that trade takes place at the Australian price-ratio of 2 units of S or 5 units of W. If Australia were to specialize completely in food production, then her maximum output of wheat would be 5 units

which she could trade for S at the assumed ratio of 5 units of wheat for 2 units of steel. Assuming that Australia would like to end up at D, then America would be able to import $2\frac{1}{2}$ units of wheat for 1 unit of steel



exports and so reach point E by trading along FE which has the same slope (represents the same price ratio) as Au Au'. In this example, the volume of trade is limited by Australia's relatively small size, but nevertheless the example illustrates two important points :

(i) Trade has benefitted America to reach a point outside its original production possibilities curve. Given the trading price ratio we were using, Australia is no better off, so all the gains have gone to America.

(ii) Even though Australia specializes completely in wheat production, America becomes more but not completely specialised in steel production.

In spite of the fact that the final price-ratio after the trade may be the same as obtaining in one of the two countries (not both) before trade, it is more likely that price-ratio will settle somewhere between the two domestic pre-trade price-ratios, both countries gaining from trade. ✓

Suppose that the post-trade equilibrium price-ratio settles down at 20 units of steel for 30 units of wheat as is shown by the new price line Au Au'. In this case, America will not gain as much as in the previous situation ; Australia sharing in the gains from trade.

For America the position of price-line is not known until we know how much steel Australia wishes to import at the given trading price ratio. Nevertheless its slope will be the same as Au Au'.

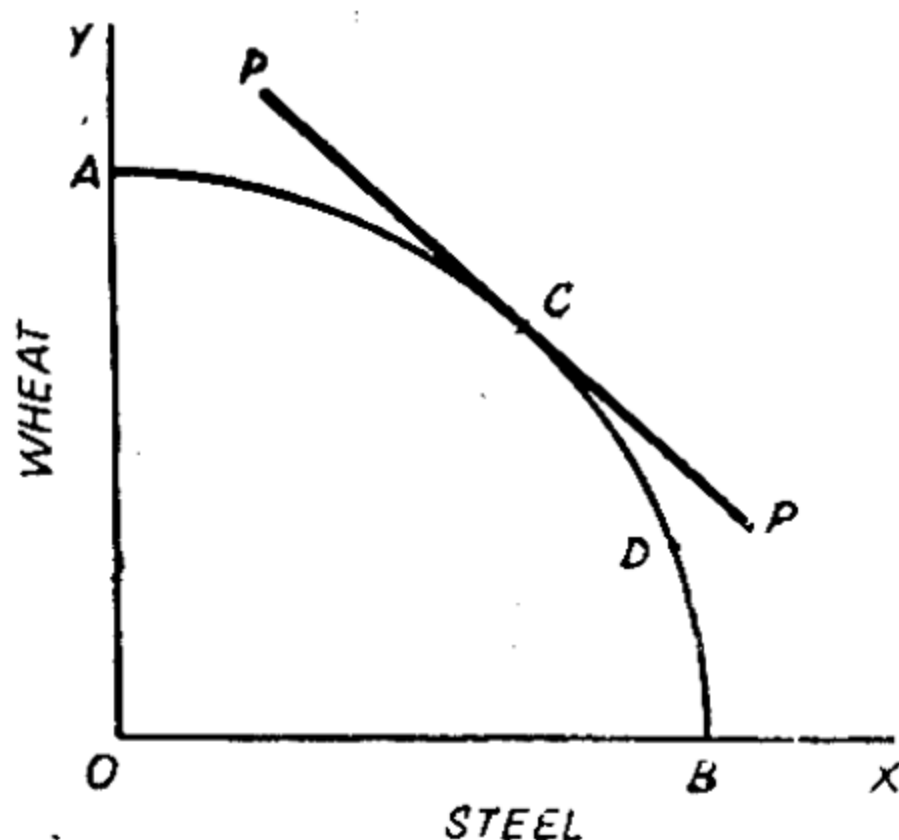
It is obvious that Australia will gain, but the actual distribution of gains will depend on what the final price-ratio is— i.e. this depends on demand factors.

However, we can say that under condition of constant opportunity costs (straight line production possibilities curve), for the maximum benefit from trade, specialisation of production after trade will be greater for both countries but may well be incomplete, for a large number of reasons some economic and some political.

Modifications to Harberler's Analysis

These consist mainly on the assumption of constant opportunity costs—i.e. the assumption that transfer of factors of production between commodities does not affect the relative efficiencies of these factors in either type of activity. We abandon this assumption.

In real life not all resources are equally adaptable in all type of activities, under more realistic conditions, then we can have situations of increasing opportunity costs causing the production possibilities curve to be concave to the origin. Over a certain range of possibilities, wheat and steel



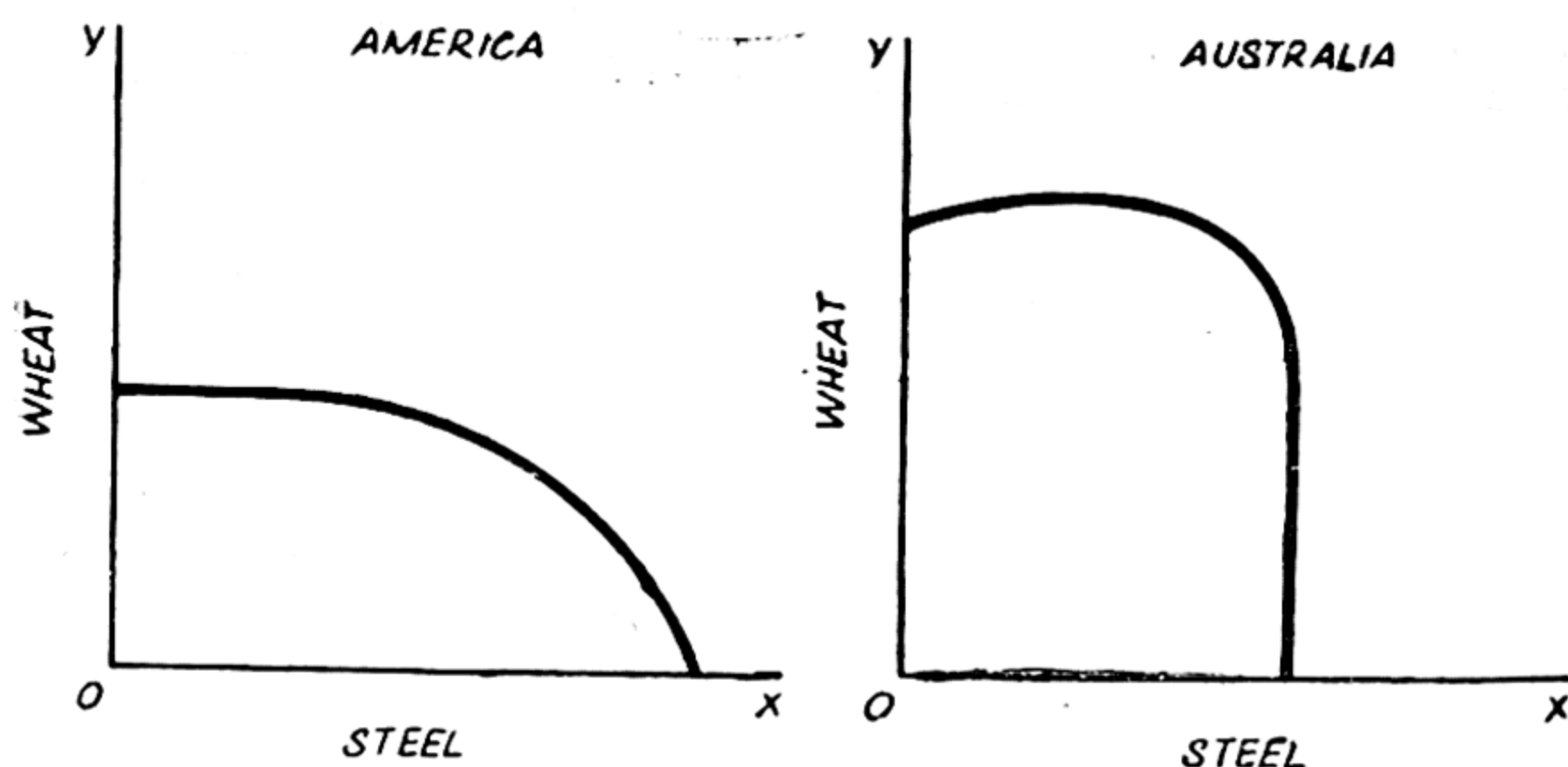
are fairly substitutable, but as we increase the concentration of production in either of these goods, the factors of production become increasingly non-adaptable. Thus, as we move down the curve from A to B, increasing the production of steel and decreasing that of wheat, the opportunity cost of steel in terms of wheat increases—we must give up more and more wheat in order to gain an extra unit of steel.

Secondly, under conditions of increasing opportunity costs, the rate at which wheat exchanges for steel will be determined by demand conditions—i.e., the slope of the price-line will be determined by demand.

Suppose, now, that the demand situation in the economy is such that the slope of PP represents the price-ratio between wheat and steel. In equilibrium, production will occur at a point on the production possibilities curve where the slope of the curve is the same as the slope of

the price-line, (i.e., at C). At C the rate of transformation into steel through production is the same as the rate of transformation of wheat into steel through trade (slope of price-line). Economy is in equilibrium.

If production takes place at a point D (other than C), then given the demand conditions, an excess of one good relative to the other will occur, creating a situation in which it would pay to shift resources out of excessively produced goods and into the scarcer good. Thus there would be a tendency to move towards C. Now, suppose, we have a situation in which the domestic price-ratios of wheat and steel are not identical in our two countries and the production possibilities curves can be shown as follows :



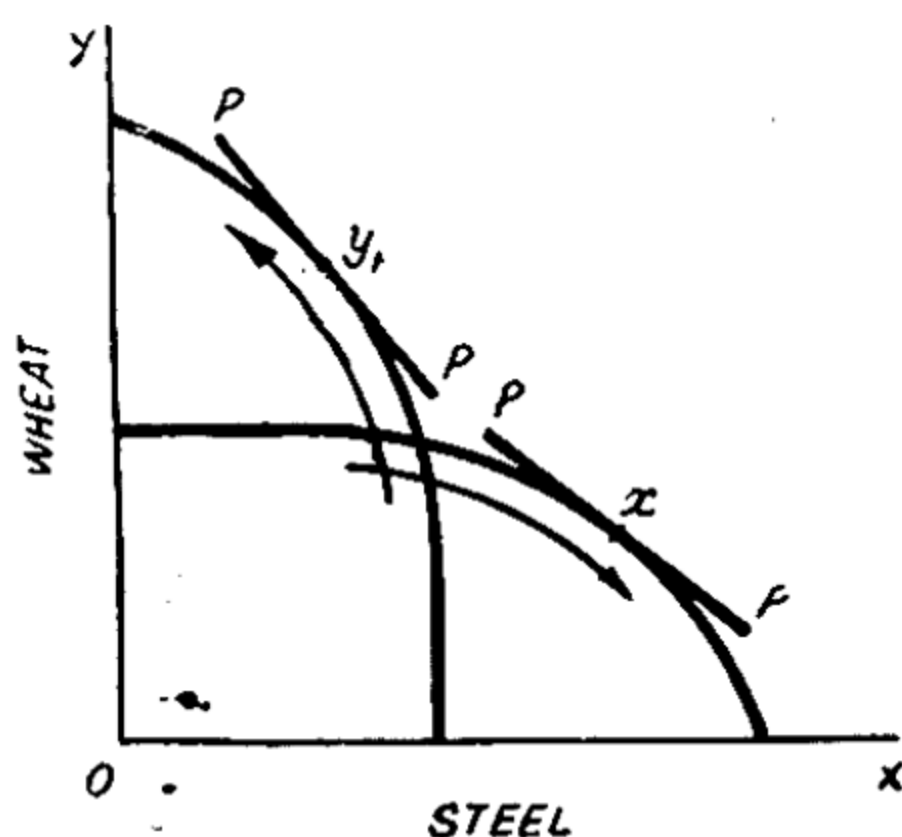
America is more efficient at steel production and Australia is more efficient at wheat production.

If we now superimpose our two diagrams, we have the diagram given on page 15. If trade takes place, an international rate of exchange between wheat and steel will develop, the exact rate depending on the demand conditions in the respective countries. Suppose the final rate of exchange settles down and represented by the slope of the price-line PP ; then in equilibrium, each country will produce at a point on its production possibilities curve where the slope of the curve are the same (X & Y).

America will move resources out of wheat production into steel production, Australia will do the converse ; America will export steel to Australia and import wheat, the exact amount traded being indetermined unless we bring in demand conditions.

America will consume at a point along PXP to the left of X, and Australia along PYP to the right of Y. By so doing both countries will be

able to move outside their original production possibilities curves and so benefit from trade. The important difference between the case of increasing



costs and that of constant costs is that under constant costs, specialisation is more likely to be complete, whereas under increasing costs, this is far less likely. Again, however, in real life, specialisation even in cases of constant opportunity costs, will not naturally be complete.

Haberler's analysis shows that even if we discard the labour theory of value as being invalid and rely on opportunity cost theory, the comparative cost theory of trade is still valid—countries will specialise in the production of goods in which they have comparative advantage, so that if the price of one good (A) in terms of (B) is higher abroad than domestically, it will pay a country to shift resources out of this former good (A) and into this latter (B), trading (B) for (A) until the prices of (A) and (B) are equal abroad and domestically. Thus differences in opportunity costs give rise to differences in comparative prices which in turn produce the countries to international trade.

The Haberler approach recognizes the existence of many different kinds of productive factors and is a major step forward from Ricardo's simple theory. The opportunity cost doctrine stresses (as the basis of trade) the differences internationally in the production possibilities curves of nations—identical absolute amounts of the factor inputs would produce different amounts of a good in different countries. Comparative cost differences arise because of production function for a given good varying from one country to another and the extent of the variation differing for various goods.

Secondly, gain from trade and specialisation exists irrespective of why a single country has a comparative advantage in one good or comparative disadvantage in another. In other words, trade is beneficial as long as

opportunity costs differ, no matter why they differ. This puts to rest immediately the cheap foreign labour and other naive protectionist arguments.

If trade is based on comparative costs which arise out of differing production functions, what causes these differences to arise. why are production possibilities curves different in different countries? This brings to the consideration of the Ohlin-Heckscher Theory of Trade.

THE OHLIN HECKSCHER THEORY OF TRADE

Q. (i) Contrast the Heckscher-Ohlin theory with the classical theory.

(ii) Review critically the Heckscher-Ohlin theory of trade.

(iii) Scrutinize carefully the assumptions inherent in the Heckscher Ohlin Model.

(iv) Discuss Ohlin theory of international trade. How far do you consider it an improvement over the classical theories in the same field?

Ans. Heckscher-Ohlin Theory contrasted with Classical Theory.

The Heckscher-Ohlin theory breaks away from the Ricardian model in several respects. In striking contrast to the latter, the former is cast with in the framework of Casselian general equilibrium theory ; being rewritten in terms of a multiple market theory of pricing, It has rescued the traditional analysis from the grip of the labour theory of value. Fundamentally more important is the second difference. By assuming one factor and constant returns to scale, the Ricardian theory renders the factor-supply irrelevant in determining this trade pattern, on the other hand the Heckscher-Ohlin model assumes two factors and makes differences in factor supplies the crucial determinant of comparative advantage. Infact, it, for the first time, integrates factor markets into international trade theory in a satisfactory way, and much of its impact has been in this field. The traditional theory consisted procuring of propositions about the relative prices of goods ; the Heckscher-Ohlin theory now offers a series of propositions about the relative prices of factors.

Thirdly, whereas the Ricardian theory attributes to international differences in production functions the explanation of comparative advantage, the Heckscher-Ohlin theory especially postulates identical production functions among nations.

Finally, the classical theory is an attempt at establishing the welfare propositions of trade theory, while the Heckscher-Ohlin theory is a contribution to positive economics—an attempt at exploiting the structure of trade.

Essence of the Heckscher-Ohlin Theory

There is no real conflict between the Heckscher-Ohlin approach and the traditional theory of comparative costs. The former establishes the latter and does something more. It establishes comparative costs as due to something more fundamental—differences in factor endowments.

The traditional theory finds the reason for trade in differences between countries, primarily differences of technique, skill, factors or all combined. But given the proposition that trade depends on differences, the Heckscher-Ohlin model seeks to find out the minimum difference between countries which would be sufficient to initiate trade. This minimum difference is a difference in the relative endowment of factors between countries.

Nor is this all. The Heckscher-Ohlin model, says Professor Lancaster, provides a satisfactory answer to the question regarding the future of trade. The traditional theory seeks to explain comparative cost differences as due to differences in knowledge or skill or some such accidents. Given this traditional view, one can reasonably conclude that in future there will no longer be any trade between countries when they have mastered each others' techniques and knowledge. But the Heckscher-Ohlin model asserts that trade would never cease even if there be perfect transmission of knowledge and techniques and absolute freedom for the costless migration of factors.

The essence of the Heckscher-Ohlin model is simply this : Trade between two countries takes place because of differences in relative commodity costs which result from two considerations. That is, two necessary conditions for trade are : relative differences in factor requirements in the production of different commodities. Relative differences in factor prices, again are traced essentially to relative differences in factor scarcities in the two countries. To quote Heckscher, "the pre-requisites for initiating international trade may thus be summarized as different relative scarcity, *i.e.* different relative prices of the factors of production in the exchanging countries, as well as different proportions between the factors of production in different commodities."

It follows, a country tends to specialize in the production of, and exports, those commodities which require for their production relatively large amounts of those factors which it has in relative abundance and which thus are relatively cheap.

ASSUMPTIONS OF THE HECKSCHER-OHLIN MODEL

The basic model is constructed from a number of explicit and implicit assumptions using a double model system, (2 goods, 2 countries, 2 factors of production). The following assumptions are made :

- (i) Perfect competition exists in both the product and factor market—in each country.

- (ii) Factor mobility within a country is complete but factor mobility between countries is non-existent.
- (iii) Factors are identical qualitatively in both countries.
- (iv) Factor supplies in each country are fixed and fully employed.
- (v) Trade is free and costless—no business of any sort and no costs of transport.
- (vi) The physical amounts of each productive factor possessed by each country can be measured.
- (vii) Technique of producing identical goods, are the same in both countries—the same amounts of factor inputs in country, applied to the production of a given commodity will yield exactly the same output.
- (viii) Goods can be classified according to their factor intensities. Relative factor prices must have no bearing, therefore on whether a good is classified as being labour or capital intensive.
- (ix) Constant return to scale applies to the production functions for goods and the production possibilities curves are concave for the origin (factors of production are partly substitutable).

Ohlin argues that once we know from assumption (vi) what the relative factor endowments are for each country, we can infer from this what the relative factor price structures will be for each country. Thus a country relatively well endowed with labour will have a factor price structure such that capital will be more expensive (earn a higher return) relative to labour.

In other words, supply outweighs demand in the determination of relative factor prices. If, however, demand for factors were to play an important role in fixing factor prices, we would have to talk in terms of economic scarcities rather than simple physical quantities and physical scarcities.

Emphasis on relative quantities should be clearly understood. For instance.

$$\left(\frac{L}{K}\right)_x \text{ may be } \frac{10}{5} \text{ units} = 2$$

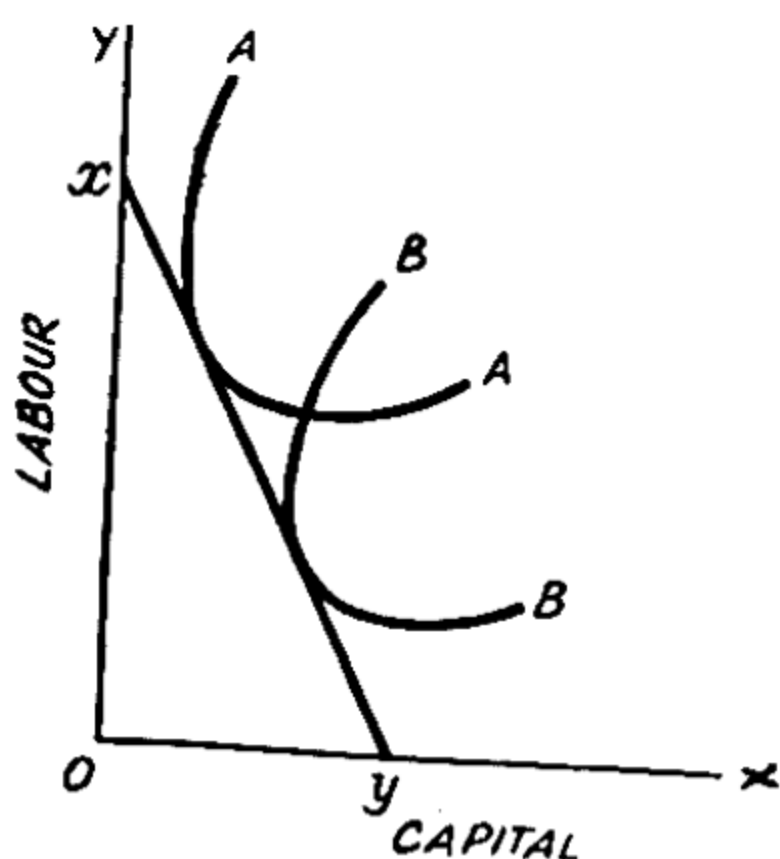
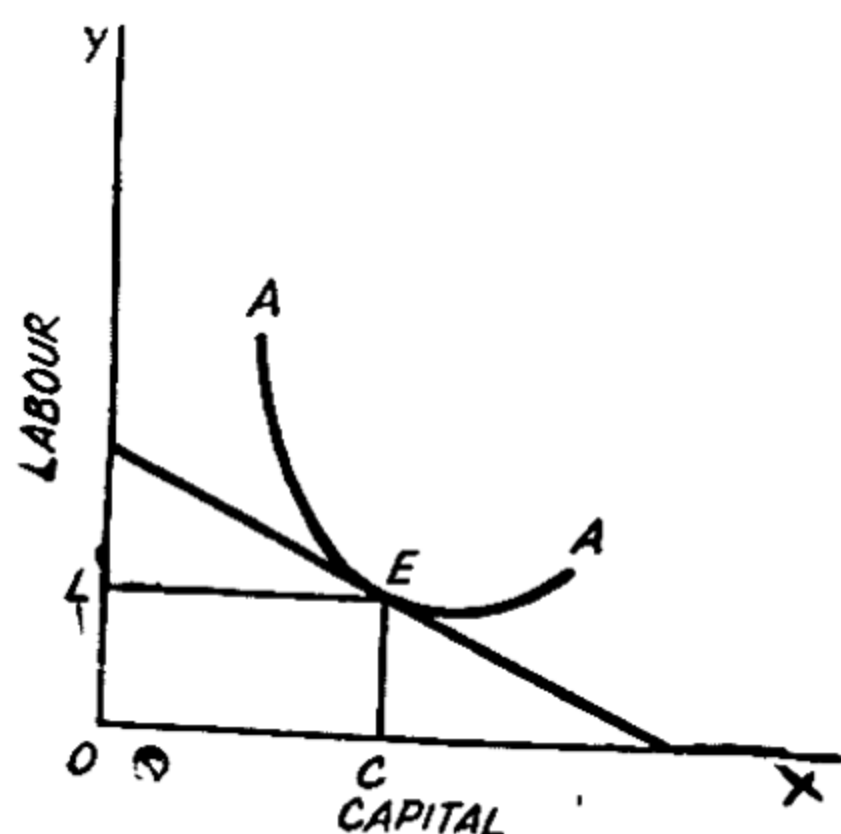
$$\left(\frac{L}{K}\right)_y \text{ may be } \frac{8}{2} \text{ units} = 4.$$

In this example country (y) though it possesses a smaller absolute amount of labour than country (x), is nevertheless relatively (i.e. relative to capital) well endowed with labour; and although the wage level in (y) may be higher than that in (x), it will be lower, relative to the return of capital in (y), than the wage level in (x).

Important assumption concerning production function (Identical production techniques) for a given good in each country means that the

isoquant map for a given period will be the same in both countries, so that if relative factor prices in both countries were the same, each country would produce the two commodities using the identical factor proportions.

Thus if in the following diagram A A represents a unit isoquant in the production of good A, then a country with a relative factor-price-structure as represented by the slope of LC, will combine its factors to



produce good A in proportions of OL of labour to OC of capital. If our other country has the same factor price structure, then since by assumption (vii) the isoquant map it faces for good A will be identical to the above, it too will combine its factors in the same ratio OL : OC.

But according to Ohlin, the factor price structure will be the same in both countries only if the relative factor endowments are identical (i.e. only if $\frac{L}{K}$ in X = $\frac{L}{K}$ in Y).

Otherwise, factor price structures will differ between countries and so each country will combine its factors in differing proportions, the labour abundant country using labour intensive production methods, the capital abundant country using capital intensive production methods.

Assumption (viii) means that the isoquant maps for different goods are different, though the isoquant map for a given commodity will be the same irrespective of nationality. Also, since if a good is classified as being capital intensive, it must remain so for all factors-price ratios, this means that the isoquants for two different goods can only cross each other once. Thus in the above diagrams at any given factor-price ratio, (i.e. ratio represented by the slope of the line XY), good A will always be labour intensive in production, relative to good B, which will be capital intensive. We can also say that a commodity can only be judged to be capital or

labour intensive relative to the production requirements of another good at the same factor price ratio.

If the isoquants intersect more than once, good A will not always be capital intensive relative to good B.

So far goods A and B are being produced in each country using identical production techniques, but with goods A and B requiring individually, differing production techniques and assuming perfect competition in both factor and product market (Ass. No. i), Euler's Theorem will hold—i.e., each factor of production will be paid the value of its marginal physical product, therefore, under Ohlin's assumptions, the actual price of a commodity must, in equilibrium, be equal to its units cost of production i.e. the sum of the capital and labour inputs per unit of output valued at their respective market rates.

Now according to the law of comparative advantage trade will only take place if relative commodity prices differ internationally i.e. the price of A relative to the price of B in country (X) must differ from the price of A relative to the price of B in country (Y). Given Ohlin's assumptions and Euler's theorem, this is the same thing as saying that the cost of producing A relative to the cost of producing B in country X must differ from the cost of producing A relative to the cost of producing B in country (Y).

Suppose, in our two countries, two good and two factor model, that country (X) is relatively well endowed with capital and that for all factor price ratios, good A is relatively capital intensive in production. According to Ohlin since country (X) is capital abundant, the price of capital relative to the price of labour will be low. It follows, therefore, that country (X) will be able to produce good A relatively cheaply and country Y will be able to produce good B relatively cheaply (simply because factors differ between two countries). The price ratio between goods A and B will differ between the two countries, therefore, and trade will take place, each country exporting the good in whose production a relatively large amount of its relatively abundant factors are required.

Thus in Ohlin-Heckscher model comparative advantages arise because of the existence of differing international factor endowment ratios and differing commodity factor intensities.

If relative factor endowments were identical and commodity factor intensities the same, no comparative cost differences (and therefore under Ohlin's assumptions, no comparative price differences) would arise, and so there would be no theoretical basis of trade. Only if there is a difference in relative factor endowments and commodity factor intensities, can trade take place, the trade pattern being such that relatively capital abundant country exports the relatively capital intensive good and imports the relatively labour intensive one. Thus in our model, the only difference between the two countries was that they had different relative factor endowments and this determined production and trade patterns.

CRITICISM OF HECKSCHER-OHLIN MODEL

Much criticism has been directed against its simplified and unrealistic assumptions :—

(i) It was assumed that factors of identical quality existed in the two countries and that these factors were capable of being measured in order to calculate factor endowment ratio's. In the real world factors are not identical in quality between countries and more than one type of each factor exists. Therefore real problems of measurement and comparison would arise in real world. Thus differing factor qualities would be a powerful influence on factor productivities, thus leading to differing international costs of production and therefore trade possibilities.

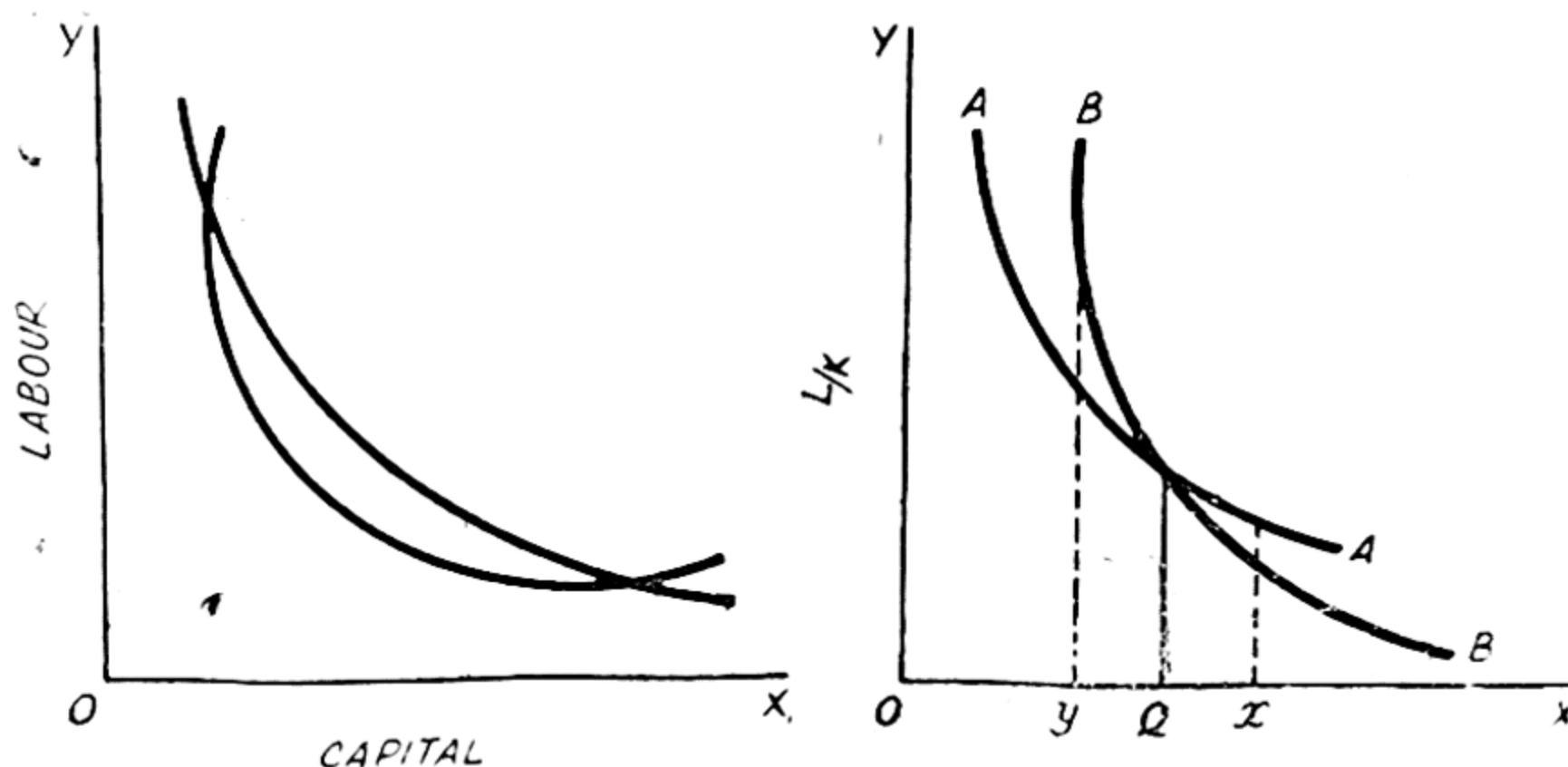
(ii) Ohlin argued that relative factor price would reflect exactly relative factor endowments. This means that in the determination of factor prices, supply outweighs demand. However, if demand for factors is important in the determination of factor prices, then it is quite possible for the labour abundant country (in the physical sense) to export the capital intensive goods. This is so, because if the labour abundant country is such that demand for labour (and therefore indirectly for labour intensive goods) is high enough, then the price of labour relative to capital will also be high and the factor price ratio $\left(\frac{L}{K}\right)$ will exceed the $\left(\frac{L}{K}\right)$ price ratio in the capital abundant country.

Also, countries with identical factor endowment ratios could engage in trade, so long as relative production costs (and therefore relative commodity prices) differed. This would be the case if the demand conditions for the factor supplies differed between the countries. Thus, unless we can assume that relative factor prices will reflect relative factor endowments, we cannot derive the basic Ohlin-Heckscher theorem as being the sole explanation of trade. If demand is an important variable in the determination of relative factor prices, then other explanations of why trade takes place are possible. Differing factor endowments could become but one explanation among many.

(iii) The assumption that production techniques for a given commodity are the same in all countries can be dropped. In such a case, comparative cost advantages may arise (depending upon the position of factor intensity curve) and lead to trade. However, the trade which takes place will not correspond to the Ohlin-Heckscher proportion. One of these countries will be exporting the good whose production requires a lot of relatively abundant factor ; the other country will export the good which requires a relatively large amount of its scarce factor.

(iv) Suppose we now retain the Ohlinian assumption of identical international production techniques but allow a situation to arise in which this factor intensity of a good is not invariant with respect to the factor price structure of the country.

If the isoquants for two commodities intersect more than once, we can no longer say that a good will be capital intensive, no matter what the factor price structure may be. Ford has demonstrated that if the isoquants intersect twice, good A will be capital intensive over a certain factor price range and labour intensive over another. Using our factor intensity curve this can be represented as follows.



Q represents what is called the factor intensity reversal point—at any factor price ratio upto Q, good A is relatively capital intensive, after Q, good B becomes relatively capital intensive. Since country (X) is assumed to be the country with relatively large supplies of capital, we could represent its factor price-structure at x. Point y correspondingly represents country (Y) factor price-structure. Country (X) would prefer to produce good B (capital intensive) and (Y) also would seem to produce good B (labour intensive) at their given factor price ratios. However, given the shapes of curves in the diagram, it is obvious that country (Y) has a comparative advantage in the production of A. When trade takes place, then the specialisation and exports of (Y) will correspond to the basic Ohlinian theorem, but those of country X will not.

Again, once we relax the Ohlinian assumption concerning the relation between factor price structures and commodity factor intensities, the trade pattern which is possible need not follow the basic theorems. This is the factor intensity reversal criticism.

(v) Another criticism of Ohlin was about his assumption of constant return to scale. However, a country, after trade, may find its market enlarged as it has to produce both for domestic and foreign market. In such a situation possibilities arise for reaping economies of scale. Consequently, the prices of goods charged by these industries (enjoying economies of scale) will be higher than actual costs, so that productions costs are no longer a direct reflection of price.

It is also possible that if scale economies were sufficiently powerful, a country with dearer factors of production could purchase a given article cheaper than the country with relatively cheap supply of factors. In this case the influence of factor prices has been overshadowed and trade could occur, purely, on the basis of increasing returns to scale.

(vi) It is also possible that due to demand preferences for the goods being produced, the commodity price ratios will fail to reflect cost ratios and so we can have situations in which the trade pattern does not correspond to the basic theorem.

Ohlin has also been criticized due to the unrealism of his assumption of perfect competition in product and factor market and complete immobility of factors internationally. The important point is that once we replace the Ohlinian assumption by more realistic ones, we are faced with a number of possible explanations why trade takes place.

- (i) Differing relative endowments ;
- (ii) Differing factor qualities ;
- (iii) Differing production techniques ;
- (iv) Consumer demand preferences.

Ohlin himself recognized the unrealism of his assumptions and attempted to modify them in constituting a subsidiary theory in which he concluded that though there were a number of reasons why commodity prices could differ internationally, factor endowments were the predominant factor in any explanation. The cause of trade for Ohlin was no different from the classical theory of comparative advantage, trade is created by differences in relative commodity price ratios. The basis of trade is given, however, by the factors which cause these commodity price ratio differences to emerge—unequal international factor endowments.

Jones has shown that the theorem is valid for a multi-commodity model as well. Given factor supply and production technique data, goods can be ranked in terms of factor ratios and therefore in terms of comparative advantages. However, demand must be introduced into the picture in order to determine which goods are exported and which imported.

However, the model has not been extended to multi-commodity—multi country analysis, which is rather unfortunate.

FACTOR ENDOWMENT THEORY TEST

Q. (i) Write a brief note on Leontief Paradox.

(ii) How far Ohlin-Heckscher model is applicable to real world ? Review the attempts made in this direction.

Ans. Macdougall, Leontief and Bhardwaj attempted to discover the applicability of Heckscher-ohlin model to real life. Macdougall compared the United States and the United Kingdom's export shares of relatively

capital intensive commodities and found that, contrary to expectations, the United Kingdom did not export to the United States goods with low capital intensity relative to labour. However, his findings have been criticised on statistical grounds and on the ground that his measure of capital intensity is unsatisfactory.

Leontief Paradox. Leontief's attempt at measuring and comparing the factor intensities of the United States exports and imports is probably the best known of all, since it comes out with the paradoxical conclusion that America exports labour intensive goods. Because of this, his conclusion is often referred to as the Leontief Paradox; a paradox since one would normally accept without question that America is relatively a capital abundant country and should, therefore, according to factor endowments theory, export relatively capital intensive goods.

Leontief undertook this analysis by considering the effects on the release of resources of a reduction of \$1 million worth of the United States' exports and imports.

Criticism. One major criticism of Leontief's methodology was that he was concerned with exports industries and competitive import replacements, not actual imports. The O-H theory applies to actual exports and import and because of this Ford argues that Leontief's conclusion is not applicable to the basic Ohlinian theorem and cannot therefore invalidate it; not only this, but one could expect American import replacement production to be more capital intensive than export production, simply because American production methods are directed towards using a relatively large amount of capital and a fair proportion of America's raw materials imports (since they may not exist in America in economic quantities) would require, if America were to produce them itself, relatively large amounts of capital.

All we can say, then is that American export capital intensive products and imports products which if it were to produce them, would require relatively more of its abundant factor.

This is a similar sort of argument to Jones who concluded that it was possible that both American export and import competing goods were produced with more capital intensive methods than abroad; since the Ohlinian theory cannot be put into reverse *i.e.*, one cannot conclude from trade patterns what relative factor endowments are, and Leontief made no effort to measure or compare relative factor endowments.

Defences In Favour of Ohlinian Theorem

1. One explanation considers foreign labour to be less efficient than American labour, and makes adjustments to show that America is relatively labour abundant. However, there is no logical reason to choose labour as the more efficient factor and reduce it to standard units. Capital

can equally be as efficient as labour. In such a case adjustment effect on factor intensity calculations may be reduced or even offset completely.

Secondly, factor intensities for the same good may be completely different between America and the countries which export these goods to America. Thus we have a case of factor-intensity reversal with the result that we cannot simply form the factor endowments which country will export which product. This could explain the Leontief's findings.

Thirdly, in real world production techniques for a given commodity will differ between countries. This can give rise to one of the countries exporting a product which requires for production a relatively large amount of its scarcer factor. Thus, we could accept the Leontief's findings without rejecting the Ohlinian theorem.

Fourthly, demand conditions in America may be such that domestic production of capital intensive goods is insufficient to satisfy this demand, with the result that America is forced to import capital intensive commodities. However, according to Brown, it appears as if America consumes relatively more of goods such as services which are relatively labour intensive.

Fifthly, Hoff Meyer argues that the Leontief paradox is due to his failure to deal adequately with natural resources. If commodities which require a relatively large amount of natural resources are excluded from the calculation of capital labour ratios, then Leontief's conclusions would be reversed—America would be found to import labour intensive goods and export capital intensive goods. Since actual American imports have an important natural resource element and since Leontief was concerned only with import replacements, it would be better to exclude the natural resource commodities from the calculations. We then have no paradox to explain.

Bhardwaj studied bilateral trade between India and America (not rest of the world). He found that for Indo-U.S. trade, the factor intensities were the reverse of those which applied to total Indian trade—India exports capital intensive goods to America and imports from America labour intensive goods.

Conclusion. On balance it would seem reasonable to say that the Ohlinian-Heckscher theorem has not been refuted. However, this is mainly because the assumptions on which it is built are so unreal and restrictive that it would be virtually impossible to devise a real world test of the theory. The theory is for all practical purposes irrefutable, and is therefore to that extent a bad theory. The theory with its assumptions has almost become a faultology—a country will export those goods using large amounts of those factors used in its exports.

In real world, many assumptions do not hold good *i.e.*, production techniques are not identical internationally, that factor qualities do differ and that factor intensities reversals are a distinct possibility. Once we

allow for these, the Ohlin-Heckscher theory becomes but one of many explanations of why trade takes place. It is not necessarily factor endowments or intensities which determine trade, but rather it is the whole complex of forces operating through supply and demand which determine whether or not trade takes place and on what terms.

Q. "International trade in commodities can be regarded as a substitute for the international mobility of factors of production." Comment.

State and explain the conditions under which Samuelson's factor price equalisation theorem is valid.

Ans. Equalisation of factor prices

Trade occurs because prices of commodities differ between different countries. Prices differ because different goods require different factor inputs and different countries have different factor endowments. Trade continues until these price differentials are eliminated. Thus trade equalises relative commodity prices apart from transport costs. In other words, trade tends to bring about the equalisation of factor prices.

The explanation is simple, but it depends upon several assumptions :

- (i) There must be as many or more commodities than factors :
- (ii) Tastes are broadly similar.
- (iii) There are identical production functions of a similar character, different as between the two commodities and each providing a limited degree of factor substitution.
- (iv) No transport costs or other barriers to trade exist to inhibit full commodity price equalisation.
- (v) Perfect competition prevails.

Exports of a country consist of products embodying the abundant factor, consequently demand for the abundant factor increases and makes it relatively less abundant. Similarly imports consist of products embodying large amounts of scarce factor. Consequently scarce factor becomes less scarce in the domestic market. Now exports tend to raise the price of the abundant and cheap factor : while imports reduce the return to the scarce and expensive factor.

In this way, the tendency towards factor price equalisation will be carried to the point where factor prices are fully equalized. The assumptions are highly restrictive and limit the conditions under which such factor-price-equalisation is achieved. "But while full factor price equalisation may be an intellectual curiosity rather than a significant proposition for the real world, the tendency toward factor-price-equalisation is much more meaningful. Trade tends to raise the price of the abundant factor and weaken the price of the scarce factor and where

trade is based on differences in factor endowments, this repercussion of trade on factor prices is vastly important politically as well as economically.¹

SAMUELSON'S CONTRIBUTION

A satisfactory demonstration of the necessary partial and incomplete character of factor price equalisation is yet to be evolved. Samuelson developed Ohlin's idea scientifically giving it a logical shape and laid down conditions and circumstances under which complete factor-price equalisation becomes not only possible but inevitable. Samuelson again makes several assumptions and those may limit the effectiveness of the theorem. However, the assumptions are :

- (i) Two countries, producing two commodities with two factors of production.
- (ii) Perfect competition prevails in both countries in product as well as factor market.
- (iii) No tariffs or barriers inhibit the movement of commodities across borders.
- (iv) No costs are involved in such movements.
- (v) While commodities are perfectly mobile between countries, factors of production are perfectly immobile between them.
- (vi) Commodities are produced under conditions of constant returns to scale *i.e.*, proportional changes in all inputs bring about proportional changes in output.
- (vii) The law of diminishing marginal productivity holds good, *i.e.*, as any one input is increased relative to other inputs, its marginal productivity diminishes.
- (viii) The production functions of each commodity in each country are mathematically "homogeneous of the first order". It is identical in both countries.
- (ix) The factors of production are qualitatively identical in both countries.
- (x) The commodities are classifiable as labour intensive, capital intensive or land intensive depending upon the factor which is used in greater proportion.
- (xi) Something is being produced in both the countries of both the commodities with both the factors of production.

1. Charles, P. Kindleberger, *International Economics* (Homewood, Richard D. Irwin, 1968 p. 33).

Suppose A and B (countries) are economically identical (all assumptions are satisfied). Supplies of factors of production are also identical in A and B. Let the factors of production be 'labour' and capital. It will follow that same price will rule in both countries and no trade will occur. Now assuming that increase of one factor capital occurs in A and assuming that no trade facilities exist, price of capital in A declines relative to another factor labour. Consequently double substitution in favour of capital occurs in A because (i) more capital will be used relative to labour in A and (ii) consumers would opt more for capital intensive products relative to labour intensive products. Demand for capital will increase and the increased supply of capital will be absorbed.

Thus as a consequence of increase in the supply of capital in A, the relative price of A's products, in the absence of trade, would change and thus would be different from what B's now are. Once trade is introduced, this cannot be a position of equilibrium. A will export those capital intensive products to B in which A's costs have become relatively lower and import from B those labour intensive products in which B's costs have become relatively lower. This will go on until equality of product prices is brought about. But that cannot happen for moderate difference in factor endowment until equality of factor prices has also been established. It follows that price of labour in B rises because the demand for B's labour intensive products has increased and demand for B's capital intensive products has fallen. Thus B's factor price ratio moves in the same direction as A's factor price ratio has moved. The full Samuelson result, that the expansion of international trade generally proceeds to such a point as will enforce, complete equalisation of factor prices, involves a further step. This is that fall in price in capital induced by expansion of supply of capital must be occurring in both the countries.

Since capital becomes cheaper, it is substituted for labour and methods of production are changed in that direction. But since there is the same relative cheapening in both countries there will be the same substitution in both countries. B's methods will still be the same as A's methods for each commodity. A concentrates on capital intensive industries to absorb its relatively more abundant supply of capital. Consequently B withdraws from capital intensive industries and concentrates on labour intensive industries. Thus some capital in B is set free which may permit of some substitution of capital for labour in these labour intensive industries. All this while there is no reason why the factor prices should be differentiated from one another. But this process has its limit and this is at the point when the process of A taking over the capital intensive industries is over and when differences in capital intensities of the industries, which are still conducted in both A and B, have disappeared.

The weakness of the theory lies in its highly restrictive assumption. These hardly correspond to real world and as such conclusions should be cautious and conditional.

Suggested Readings

1. Charles P. Kindleberger : International Economics
2. G. Haberler : The Theory of International Trade.
3. David Young : International Economics.
4. American Economic Association : Readings in International Economics.
5. American Economic Association : Readings in the theory of International Trade.
6. C.P. Kindleberger : Foreign Trade and the National Economy.
7. S.C. Nandwani : Trade Dilemma of Developing Countries.

THE PURE THEORY OF INTERNATIONAL TRADE : DEMAND

- Q. (i)** Examine the nature and importance of the Principle of reciprocal demand in the theory of comparative costs.
- (ii)** Discuss the various concepts of Terms of Trade. Do you think that deterioration in the terms of trade necessarily means loss of economic welfare.
- (iii)** How would you define the gains from international trade ? Do you think that the distribution of gains depends upon the size of the country. Give reasons for your answer.
- (iv)** Distinguish between (a) commodity terms of trade and factor terms of trade and (b) gross barter terms of trade and net barter terms of trade. Which of these would you rely upon as an indicator of the gains from trade.

The Law of Reciprocal Demand.

The Ricardian theory of comparative costs can be looked upon as a highly simplified model which was intended to be, and served as, an eminently successful instrument for establishing the welfare proposition that trade is beneficial. However, he has not shown how the gains from trade are divided among the countries i.e. how the exact ratio of interchange between the trading goods is determined. John Stuart Mill, the last great classical economist, established that the barter terms of trade between two countries are settled by equation of international demand which is sometimes called the principle of reciprocal demand.

The ‘barter terms of trade’ refer to the amount of an imported good that trades evenly for some amount of an exported good. According to Mill, the barter terms of trade, depend not only on the cost conditions but also on the demand condition. Stated briefly, Mill’s doctrine is : The actual ratio at which goods are traded will depend upon the strength and elasticity of each country’s demand for the other country’s product, or upon reciprocal demand. The ratio will be stable when the value of each country’s exports is just enough to pay for its imports.”

The essential features of Mill’s law of reciprocal demand are :

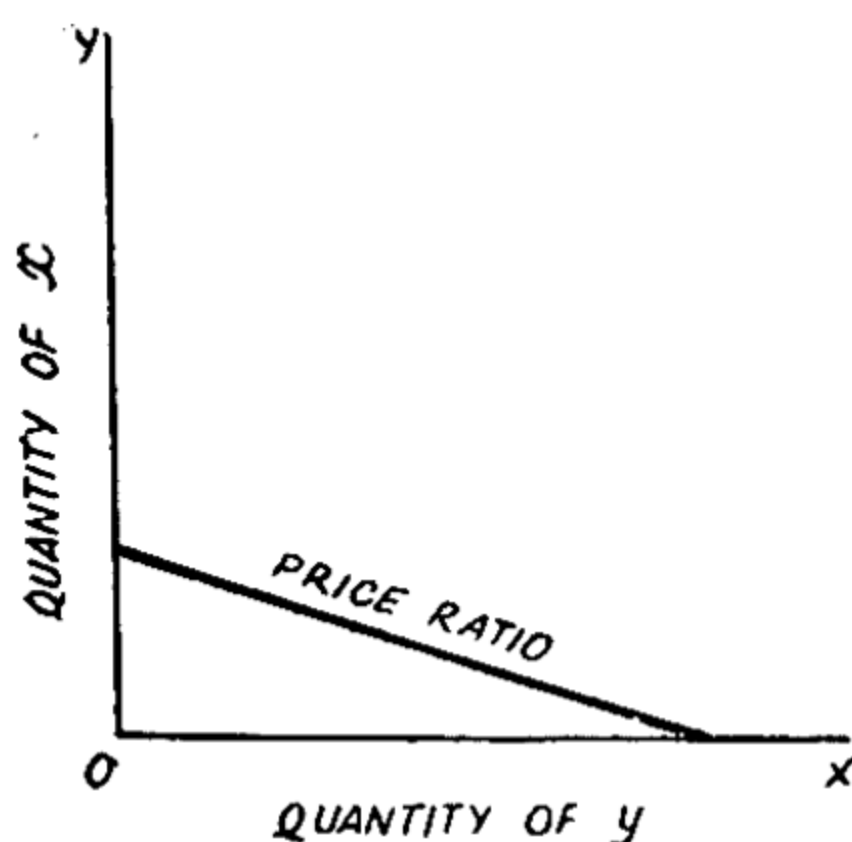
- (i)** The limits within which the barter terms of trade must lie are

given by the respective domestic cost ratios as set by the comparative efficiency in each country.

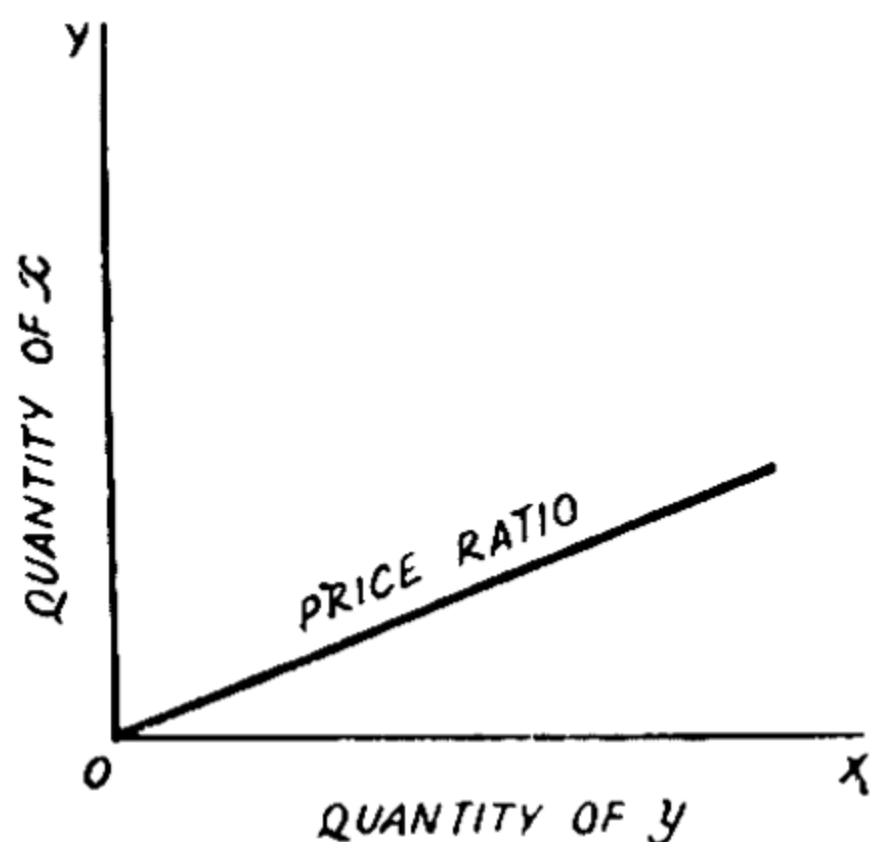
- (ii) Within these limits, the actual terms depend on each country's demand for the other country's product ;
- (iii) The stable barter terms will be those at which the goods demanded by one country are equal in value to the goods demanded by the other.

Marshall-Edgeworth Offer Curves

The theory behind Mill's law of reciprocal demand has been portrayed graphically by Edgeworth and then by Marshall with the so-called offer curves. They start out with a somewhat different geometrical perspective than products on possibilities curves. In figure [A] we show a price ratio between x and y , which is the same as the production possibilities curve with constant costs. As a production possibilities curve we are concerned with the increase in the production of one good as the other's production is decreased, *i.e.* in the absolute value of the curve. As a price, however, we are interested merely in the quantity of x which has the same value as quantity of y , *i.e.* in the slope of the line. In this case the negative slope, that is the downward slope from left to right, has no significance



[A] Relative Prices of x and y



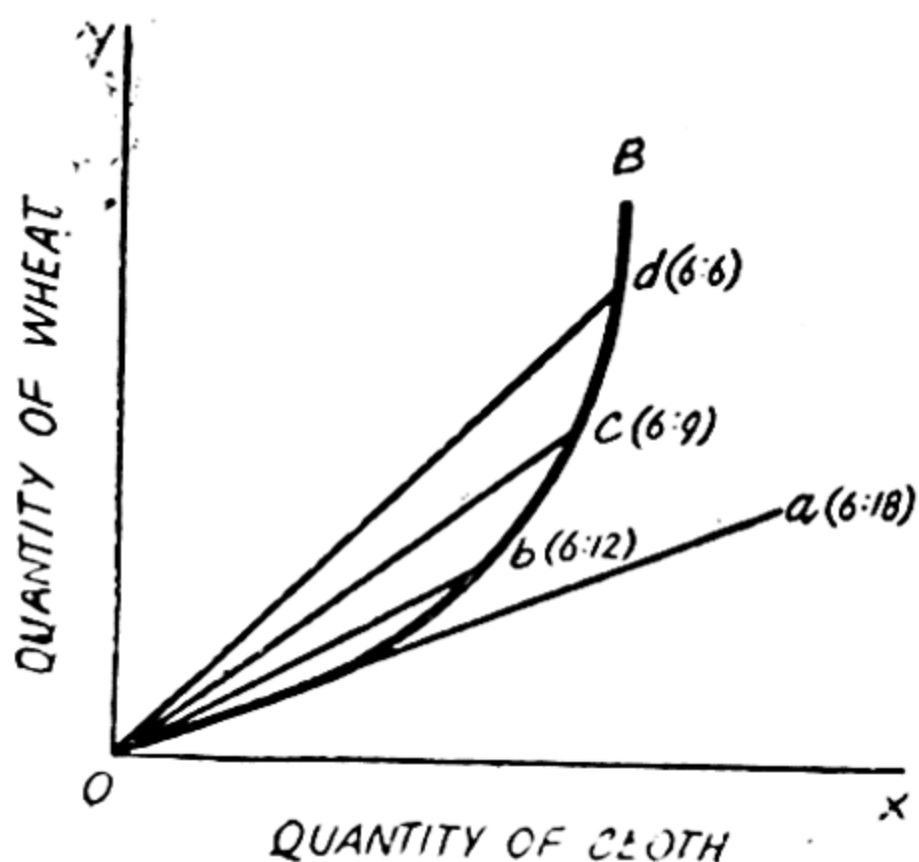
[B] Relative Prices of x and y

and we can draw the line X with a positive slope from the origin (O). In figure [B] the price ratio between x and y can be extended any distance to show what quantity of x will be exchanged for what quantity of y .

The offer curve of a country, *i.e.* the amount of wheat it is willing to offer for cloth, may start out like this price curve. In any event the price is a limit beyond which the offer curve cannot go.

Figure [A] portrays the British offer curve, $O-B$, which shows the amounts of cloth Britain will offer at various prices for given amounts of

wheat. Line 'a' is the ratio at which cloth and wheat exchange in the absence of trade (6 bushels against 18 yds). The offer curve can be regarded as a supply curve in international trade, represents various amounts of cloth which Britain is willing to exchange against specified amounts of wheat. Or it can be regarded as a demand curve (of a special sort), indicating given amounts of wheat which Britain is interested in acquiring for specified amounts of cloth. The offer curve is derived by ascertaining the amount of cloth which Britain wants to exchange for wheat, or wheat which it wants to acquire against cloth, at various prices for the two commodities, are in terms of the other. The offer curve connects up the amounts which Britain wants to trade at various prices, and includes the straight line portion where Britain is indifferent to trade whether it trades or not.



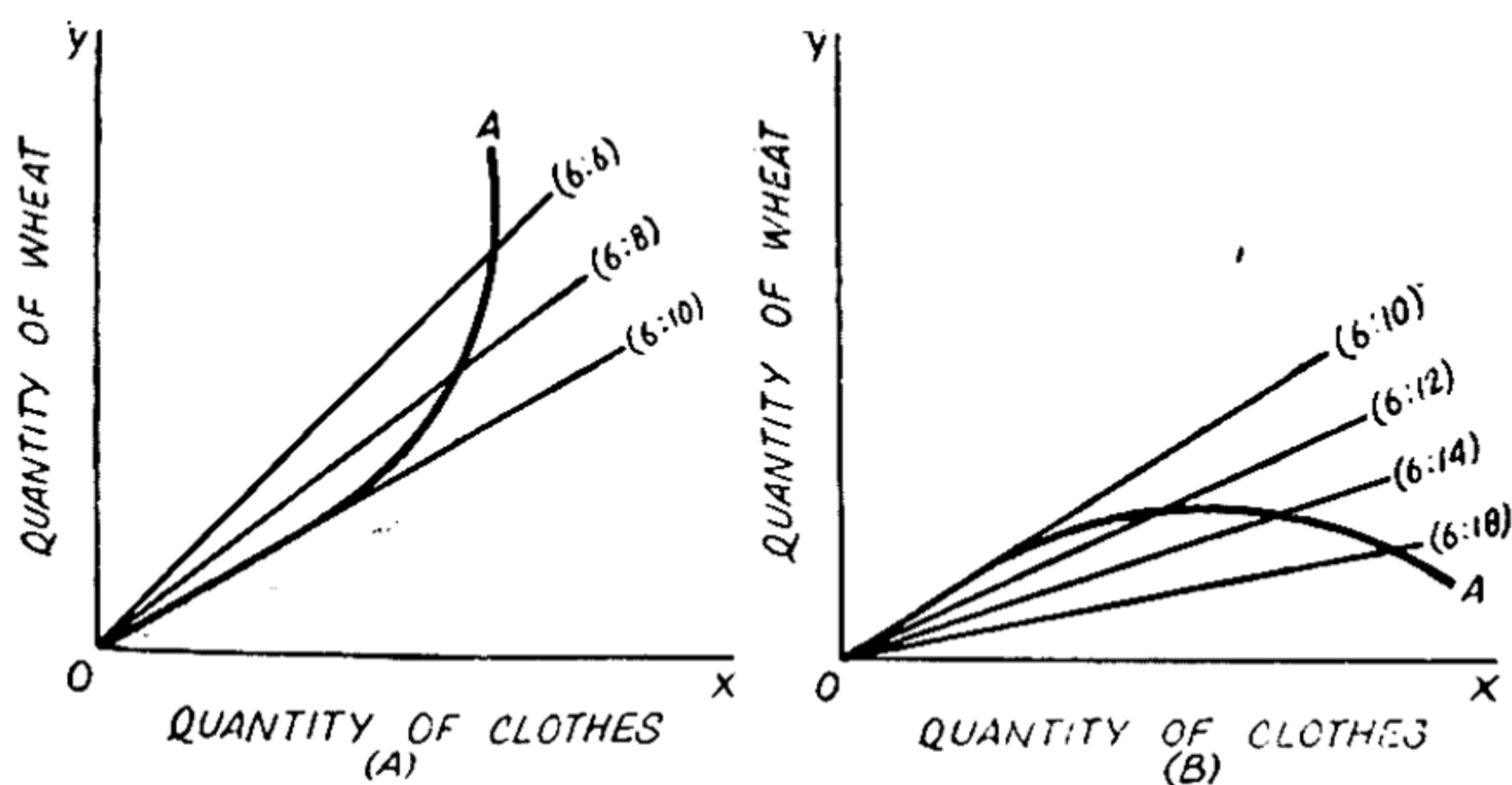
Britain's offer curve of cloth (Demand for wheat)

Beyond the position of the curve where it is indifferent to trade, Britain is likely to offer less and less cloth for wheat as more and more wheat becomes available. In part this will be because Britain wants wheat less ; in part because cloth becomes more valuable as its supply is reduced through exports. At some point such as Britain may be unwilling to give up any more cloth for additional wheat. At this point Britain's offer curve, interpreted as a demand for wheat against cloth, has unitary elasticity, in that it is prepared to offer only the same amount of cloth for larger amounts of wheat. As a supply of cloth offered for wheat, the offer curve has zero elasticity, since the supply of cloth is invariant to increasing amounts of wheat offered in exchange. The point to be noted is that the elasticity of the offer curve can be interpreted in various ways : as an import elasticity reflecting the change in imports corresponding to a change in price ; as an export elasticity, representing the change in exports associated with a change in price ; or as a total elasticity, which is

the per centage change in imports relative to the per centage change in exports at a point on the curve. The most usual concept of elasticity of the offer curve is the import elasticity.

The offer curve is not an ordinary demand or supply curve, of course. As a demand curve, for example it expresses the demand for one commodity (imports) in terms of the supply of another (exports), whereas normal demand curve expresses the demand for a given commodity in terms of money. The money measure used, however, is price per unit not total money spent. If the second commodity be regarded as money, which is possible, the offer curve would be a demand curve in terms of quantities of commodities against total amount of money. It would be a total revenue curve as opposed to a demand curve, which compares quantity with average revenue per unit.

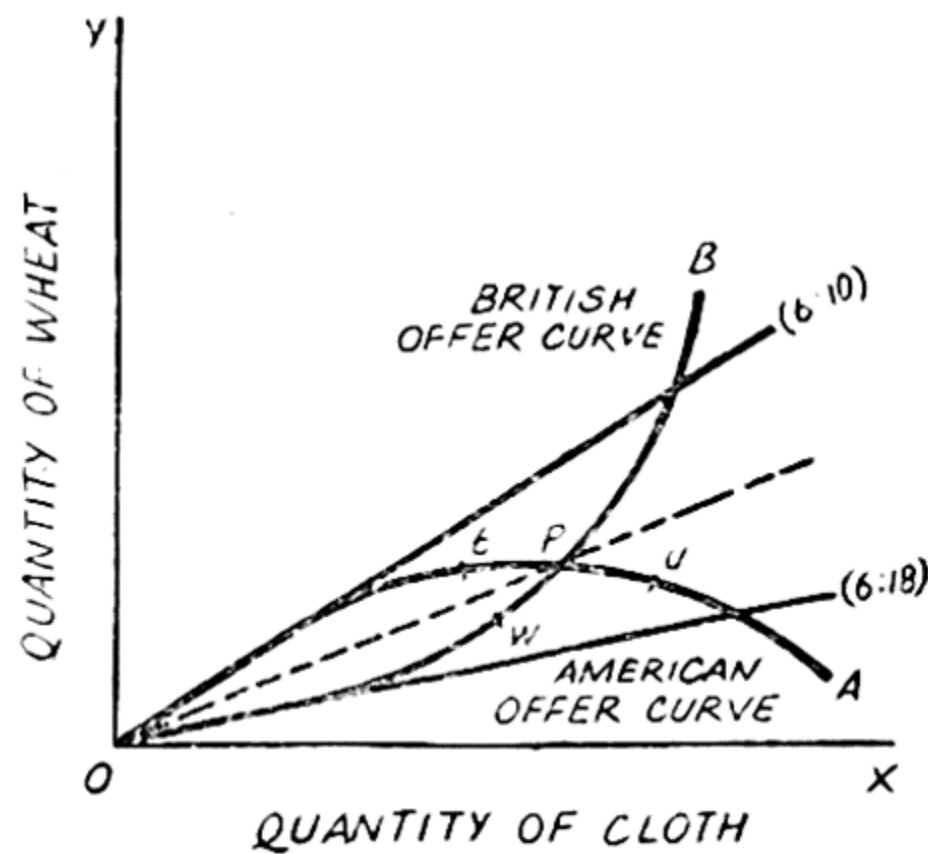
The United States' offer curve of cloth for wheat (similar to British offer curve) is shown below (Figure A) starting from the 6 : 10 domestic U.S. ratio, rather than the British ratio of 6 : 18. But there is no one to offer wheat for cloth at prices for cloth above 6 : 10. The real issue is what the United States will trade at lower prices for cloth, or higher prices for wheat. The offer curve must bend down as in [Figure B].



The United States Offer curve of wheat. (Demand for clothes)

If the offer curves for the United States and Britain now be taken on the same basis, they will cross. This point P (as shown given on Fig. page 34) will show where our auctioneer would get the same price for wheat and cloth in both countries (O—P) and equal amounts of wheat and cloth exported and imported by the United States and Britain. At any point than P—say, *t*—the United States would be willing to pay broadly as much wheat as at P for a good deal less cloth. But for this amount of cloth,

Britain is willing to accept a good deal less wheat, as indicated by the point W. Neither t nor W can serve as a point of equilibrium, because



A. Law of Reciprocal Demand : Intersection of Two Offer Curves.

the terms of trade implied by the ray from the origin to each point do not suffice and clear the market. At the relatively high price for wheat in terms of cloth represented by $O-W$, for example, the British would offer only a small amount of cloth and the United States would want considerably more (see point U) quantities of the goods produced. It is the demand condition that helps to settle the quantities of goods to be produced and exchanged. One cannot dispense with the law of reciprocal demand in such increasing cost condition.

INDIFFERENCE CURVES

Q. (i) Examine the difficulties that arise in affecting transaction from individual indifference curves to community indifference curves.

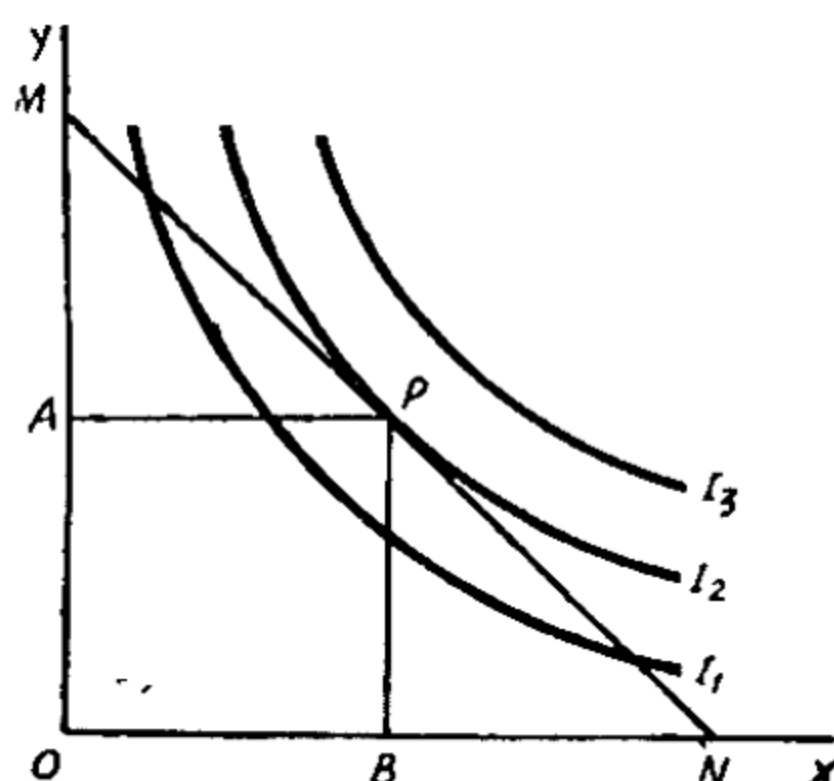
(ii) "However unrealistic, the community indifference curve is schematically a neat device" Discuss.

Ans. Considering two commodities, an individual's indifference curve is the locus of all those combinations, each of which gives the consumer the same level of satisfaction. The consumer feels neither better off nor worse off as he moves from one point to another on the same indifference curve, even though the commodity composition in his possession changes. Higher curves of course, give the consumer relatively greater satisfaction.

An individual indifference curve is characterised by three properties. (i) An indifference curve must be negatively sloped. It implies that if the consumer is to remain indifferent between points on the same curve, the quantity of one commodity in his possession must increase as that of the other decreases. (ii) The curves are non-intersecting; it follows from the assumption that the consumer 'preference' and 'indifference' are both transitive. (iii) Each indifference curve is convex to the origin; it means,

that the slope of the curve which is called the marginal rate of substitution between two goods, must be diminishing.

Let us now examine the consumer equilibrium consumption between two goods X and Y. Assume that the price ratio between X and Y is given by the slope MN as shown in figure given below; assume also that the consumer is provided with a level of real income indicated by a given indifference curve I_3 . In this case the consumer's equilibrium consumption of



the two goods is indicated by the point of tangency of the price line with given indifference curve. P is such a point in the above figure.

If now the price changes, but the consumer's level of real income remains unchanged, the consumer equilibrium consumption will be denoted by a different point on the same indifference curve. Thus an individual indifference curve shows all those combinations which a consumer with a given utility level would purchase between two goods as the price between them is varied. In other words, the indifference curves consist of a series of points indicating quantities of two goods, which would be bought with a given level of real income at an infinite series of prices of one good in terms of another.

Objections to the Use of Community Indifference Curves.

The difficulty arises in affecting transition from individual indifference curves to community indifference curves. Inter-personal comparisons are difficult. It is difficult to infer that the gain in satisfaction of one is greater than the decrease in the satisfaction of the other. Even if changes are evenly distributed, some may prefer one good strongly over another and others may do oppositely. It is not legitimate to compare levels of satisfaction from one person to another.

GRAHAM'S CRITICISM OF THE RECIPROCAL DEMAND THEORY

Professor Frank D. Graham, a distinguished critic of the classical trade theory, has attacked the law of reciprocal demand on the ground

that in determining international values it concentrates only on demand to the complete neglect of supply. This is justified if the theory of trade is constructed in terms of fixed quantities of production ; but since in practice, trade occurs in goods the supply of which continually fluctuates, supply condition must be taken into account in ascertaining the exchange ratio.

Graham proceeds further and states that the idea of reciprocal demand is not at all necessary in the theory of international value. Under constant cost assumptions, the supply conditions suffice to settle the final exchange ratio, (called by Graham the Limbo ratio) some where in between the two domestic cost ratios. This is indeed the case, says Graham, if the countries are of the same size and the two commodities traded are of about the same importance. But if one of the two countries is very large compared to the other, there is the overwhelming possibility that even after trade one of the two goods will be produced in both the countries ; in that case the final terms of trade will coincide with the domestic cost ratio of the country producing both the goods. Such a situation, in which trade takes place between a very large country and a very small country was to Mill an extreme and barely conceivable case, but to Graham this is the normal case. The persistence of this common commodity after trade means that supply or cost conditions are the only determinant of international values. This possibility only increases, says Graham, if there are more than two commodities and more than two countries. For when more than two countries are involved, at least one country is likely to produce both goods even in the post-trade situation ; under the assumption of constant costs, the final exchange ratio will then settle at the domestic cost ratio of this country, rather than at some "limbo ratio" in between the domestic cost ratios of the trading countries. From this Graham concludes, that the conditions of demand have no influence at all upon the real international exchange ratio, and hence the law of reciprocal demand should have no place in the theory of international trade.

Graham's argument is correct as far as it goes. It is indeed true that with constant costs and with incomplete specialisation in one country at least, the domestic cost ratio of this country determines the price at which all must trade. But under conditions of increasing costs every country produces some of each good ; this fact of incomplete specialisation, does not set the terms of trade. Under increasing costs, the pre-trade domestic cost-ratio is no longer independent of the supply condition.

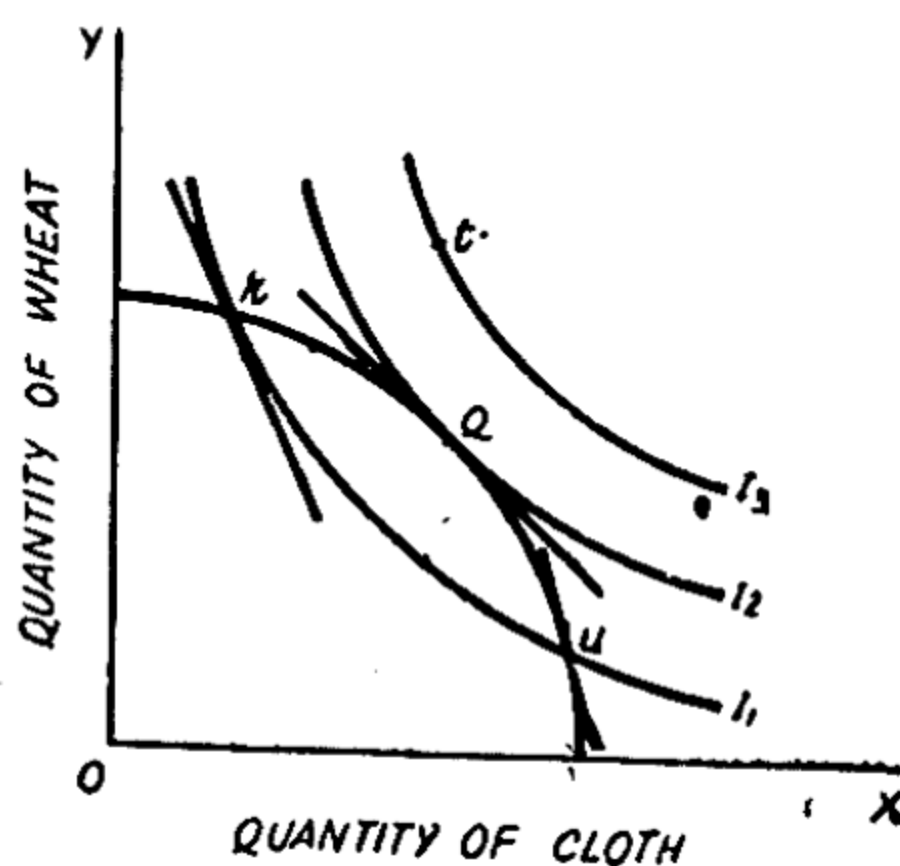
Another objection to the use of indifference has been noted by Professor Johnson. Income distribution in a free-enterprise-economy takes place according to factor ownership ; unless ownership shares and individual tastes are identical, any change in production will alter factor prices, and therefore shift the weight given to the different people's preferences in adding up social preference scale.

Professor Scitovsky has constructed community indifference curves

with the help of the compensation principle devised by a group of new welfare economists. The principle holds that a reorganisation should be approved if the gainers can compensate the losers and still be better off, and if the losers cannot bribe the gainers in advance. Some meaning can therefore be attached to these curves if the compensation principle is found meaningful. But like all other welfare criteria, this has proved to be an abortive effort for passing on the welfare effects of an economic change. Moreover the principle involves a strict value judgment which is not universally acceptable. To quote Professor Baumol, "We are not entitled to say merely because one part of the group is able profitably to compensate its other members for any inconveniences caused to the latter that the change in question necessarily involves a gain to the group." Infact as the trenchant criticisms of Little, Arrow and others suggest, there are insoluble difficulties in measuring and comparing different peoples' utility, and therefore, the principle has nothing to recommend itself.

According to Professor Metzler indifference curves for a country as a whole depend both upon the real national income and upon its distribution between different individuals. Since international trade affects the distribution of income, it also produces a shift in the community indifference curves. Is it not then impossible to derive meaningful indifference curves for the country as a whole.

According to Kindleberger, "However unrealistic, the community indifference curve is schematically a neat device." In the first place, it provides us with the answer to the price at which wheat and cloth will be traded in the two communities with decreasing returns and in the absence of trade. The price which will prevail in the single market is that which is tangent both to the production possibilities curve (AB) and to the highest possible indifference curve (I_2). Production and consumption will both take place, in the absence of trade, at this point of tangency. This is shown by point Q in figure below. At point on a lower indifference curve,



satisfaction can be increased by shifting production towards wheat away from cloth, or vice versa point r , for example, represents the quantities of wheat and cloth which consumers would take at a price for wheat and cloth in terms of each other tangent to indifference curve I_1 at r .

But at this price, maximum production would require output at V . The price of cloth is so high in terms of wheat that resources will be shifted from wheat to cloth. But this production cannot be sold at these prices. There is far too much cloth and far too little wheat to satisfy consumers, who at this price would consume more wheat and less cloth. In order to get rid of output, the price of wheat will have to be raised and that of cloth will have to be lowered. This means another shift of production from V . And so it would oscillate, first consumers and then producers dissatisfied with the combinations of wheat and cloth until a stable equilibrium is found at the point where the production possibilities curve is tangent to the highest possible indifference curve.

As long as decreasing returns exist, there will always be such a point, while there is only one production possibilities curve, there are an infinite number of indifference curves which can be drawn representing infinitesimally small increases in real income. If these indifference curves do not intersect, any production possibilities curve must produce one point of tangency to a family of indifference curves.

The slope of this tangent is the price line. It is also the marginal rate of substitution in consumption, on the indifference curve, and the marginal rate of transformation on the production possibilities curve. When the price ratio equals the marginal rate of substitution in consumption, consumers are in equilibrium. When the price ratio equals the marginal rate of transformation in production, producers are in equilibrium. When the marginal rate of substitution in consumption equals the marginal rate of transformation in production, without external trade, producers and consumers are both in equilibrium, and markets are cleared at existing prices.

Measuring Changes in the Terms of Trade

1. Barter Terms of Trade.

Statistical technique during Mill's time was inadequate and an accurate measurement of changes in the country's terms of trade was not possible. Today we measure changes in the barter or commodity terms of trade over a period by comparing the changes in the country's import prices with changes in its export prices. A reduction in import prices means that a country can obtain a larger volume of imports than hitherto in exchange for a given quantity of exports. We measure such an improvement by an increase in T_a , where T_a stands for a country A 's barter terms of trade and where

$$T_a = \frac{PE_1}{PE_0} \div \frac{PM_1}{PM_0}$$

PE_0 = the average price of exports at the base date

PE_1 = the average price of exports at the subsequent date

PM_0 = the average price of imports at the base date

PM_1 = the average price of imports at the subsequent date

If over a period export prices rise more than import prices, then taking the ratio of export prices to import prices on the base date as 100, the index will show a value greater than 100. The change in the index can either be expressed as the ratio of export price index to the import price index or as the ratio of the import price index to the export price index. This is sometimes referred to as an improvement in the terms of trade. Although it is generally assumed that an improvement has taken place in the country's term of trade when its export prices rise in relation to the prices it pays for imports, a distinction should be made between a relative rise in export prices due to changes in demand conditions abroad for a country's product or are due to rising domestic costs, only the former represents a genuine improvement in the country's external position. Accordingly one should distinguish between a deterioration in the country's terms of trade due to cost reductions and the one due to the fall in the overseas demand for its product. A reduction in export prices due to an improvement in efficiency reflects itself in the index differently from a reduction resulting from declining foreign demand.

FACTORAL TERMS OF TRADE

Marshall made use of this concept in developing his offer curves. The representative bales of E and G goods traded between England and Germany are such that each contains the product of a constant input of resources. If England gives up more E goods in exchange for a given quantity of G goods than hitherto, this means more of England's resources are devoted to obtaining a given volume of imports. There is thus a real deterioration in the external position of U.K. The factorial terms of trade index shows whether increased resources have to be used to obtain a given volume of imports. It can be calculated by multiplying the barter terms of trade index by an index of productivity changes in export industries and can be expressed as $S_a = T_a \cdot Z_a$, where

S_a = country A's single factorial terms of trade

T_a = country A's barter terms of trade

Z_a = Index of productivity in A's export industries

If a country's export industries become more efficient, its factorial terms of trade might improve, although it suffers deterioration in its barter terms of trade. A more refined picture is obtained when we take into account the productivity changes in the export industries of countries supplying its imports. This time we take into account not only the real effort put into country A's exports but also the real effort put into

country A's imports by the supplying countries. The index measuring this is the double factorial terms of trade :

$$D_a = T_a \times \frac{Z_a}{Z_b}, \text{ where}$$

D_a = country A's double factorial term of trade

T_a = country A's barter terms of trade

Z_a = index of productivity in A's export industries

Z_b = index of productivity in supplying countries' export industries

In practice, an index of double factorial terms of trade is almost impossible to calculate, since it involves measuring and comparing productivity changes in the export industries of a large number of countries. Moreover, even if it were possible to produce, such an index would be of less value as a guide to policy-making than the simple factorial index. After all, the citizens of a country are interested in the total volume of goods that they can obtain from a given real effort in the relative efficiency or otherwise of other countries. The single factorial terms of trade index focuses attention on something which is susceptible to policy—namely domestic efficiency. Adjusting for productivity changes in other countries is only likely to obscure its message.

The barter terms of trade index is concerned only with unit values. It tells us nothing about the quantities of goods traded. If, for example, domestic inflation causes export prices to rise and if foreign elasticity of demand is more than zero, the volume of goods exported will decrease. But this will not be reflected in the index. Accordingly a country might find that an apparent improvement in its barter terms of trade results in deterioration in its trade balance. Taussig suggested avoiding this difficulty by using what he called the cross barter terms of trade. The index is simply the change over a period in the ratio of physical imports to physical exports. A change in the gross barter terms of trade facing a country A can be measured as follows :

$$G_a = \frac{Q_a}{Q_b}, \text{ where}$$

G_a = country A's gross barter terms of trade

Q_a = volume of country A's exports

Q_b = volume of country A's imports

The higher the ratio, the greater the improvement in a country's gross barter terms of trade. For it means that a bigger volume of imports can be obtained from the same volume of exports.

The concept has also been criticized, for although it takes account of the quantities of goods moving from one country to the other, these may include multilateral transfers. We cannot distinguish various types of multilateral transactions lumped together in the index. As Haberler remarks, "It will not do to lump together in one category these different kinds of payments."

INCOME TERMS OF TRADE

A more recent approach to the terms of trade question is that of Dorrance, who uses the concept of income term of trade. The index which takes account of the volume of exports of a country as well as its export and import prices is designed to show changes in a country's capacity to import in exchange for exports. It accordingly takes into account changes in export and import prices (the barter terms of trade) and the volume of exports. A change in the income terms of trade is measured as follows :

$$I_a = T_a \cdot Q_a, \text{ where}$$

I_a = country A's income terms of trade

T_a = country A's net barter terms of trade

Q_a = country A's export volume index

The index is accordingly calculated by dividing the index of the volume of exports by an index of the price of imports. A rise in the value of the index of the income terms of trade indicates that a country can obtain a larger volume of imports than before from the sale of exports. Its capacity to import has increased. A country's income terms of trade can improve while its barter terms of trade deteriorate, for with constant import prices, a fall in export prices might be accompanied by an increased scales such that the total value of exports rises.

The indexes mentioned above are sometimes useful in shedding light in a particular country's economic problems. They are at least useful aids in clarifying the forces affecting the gain a country derives from trade. Some methods may be more appropriate than others for a particular purpose. If, for example, we wish to assess the impact of changing commodity prices upon the ability of a less developed country to carry out an import programme, Dorrance income terms of trade may be more appropriate. This index tells us whether a fall in such a country's export prices results in a sufficient increase in the export volume to offset the deterioration in the commodity terms of trade. But whatever index of the terms of trade is used, its message must be interpreted with care and caution.

Suggested Readings

1. Charles. P. Kindleberger : International Economics
 2. American Economic Association : { Readings in
the Theory of
International Trade
 3. David Young : International Economics
 4. American Economic Association : Readings in International
Economics
 5. C.P. Kindleberger : Foreign Trade and the National
Economy
 6. G. Haberler : The Theory of International
Trade
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THE COMPARATIVE STATICS OF TRADE CHANGES IN TASTE, FACTOR ENDOWMENTS AND TECHNOLOGY

Q. Discuss what happens when classical assumptions about fixed tastes, fixed resources and fixed technology are changed ?

How would you explain the basis of trade when classical assumptions are relaxed ?

Ans. A case for specialisation and exchange is made on the basis of given tastes, given production functions, fixed factor endowments. The reality is different. Hence we choose to depart from several assumptions.

Changes in Tastes

(Historically tastes have changed with trade. Trade has given rise to new wants and these have necessitated greater trade. Ragnar Nurkse has propounded the theory of "demonstration effect." Under this effect, developed countries have made the developing countries conscious of better and different ways of satisfying wants. Modern methods of production may be introduced. These soon lead to changes in consumption and make them modern.

(When price of exports rise or that of imports fall, trade results in unambiguous gain for the country provided tastes and means of production are unchanged. However, fall in prices of imports may be accompanied by a change in favour of imports, and concept of unambiguous gains may not hold.) A new want has arisen and has been satisfied by trade. This is a departure from the classical assumptions and raises doubt as to the classical conclusion of gains. (With the change in tastes, there is a change in consumption indifference map, as well as the trade indifference map hence there is no basis for measuring gains or losses from trade.)

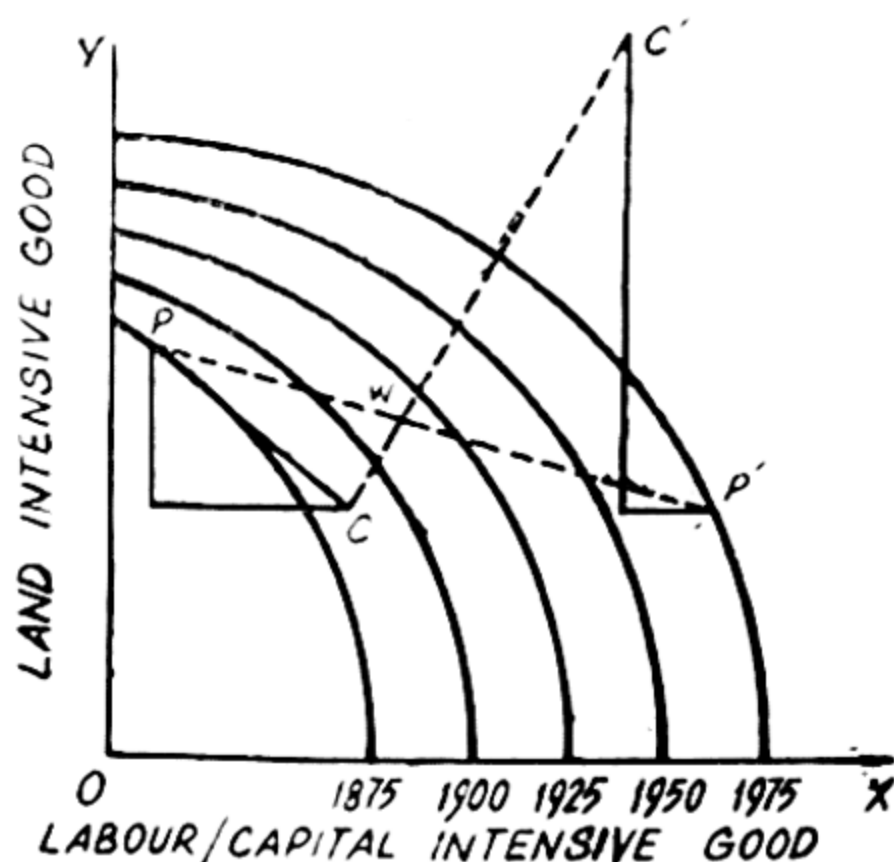
Demonstration effect is stronger today than it was before World War I. Earlier different styles of national diet and cooking continued with trade, now the trend is towards uniformity throughout the globe. This tendency is especially apparent in the developing countries : for instance their demand for Swiss Watches, U.S. fountain pens, Japanese transistors, Japanese Terylene, etc. Sometimes the equipment may be so efficient that

everybody may wish to have it. Here taste becomes responsive to changes in technology.

Changes in Factor Endowments

(Factor endowments are not fixed. Capital and labour grow. Land is relatively fixed. Though in the economic sense land may be growing. However, we assume that land is relatively fixed. The result is that comparative advantage changes. The United States used to be an exporter of wide variety of metals and minerals. Now it is a net importer of all but two—coal and molybdenum. Copper, zinc, lead, iron and especially oil which were exported, are now imported. Figure (below) shows the nature of the change. The vertical axis measures land intensive goods; the horizontal axis, represents the goods embodying primarily labour and capital. The inner production possibilities curve, marked 1875, shows a strong specialisation in land intensive production, which is in part exchanged for labour/capital intensive goods. With the passage of time the shape of the production possibilities curve changes.

A Schematic Representation of the change in U.S. Comparative Advantage in Land Intensive Commodities to Comparative Disadvantage.



Land is fixed, and capital and labour grow. Production possibilities in the land intensive product increase somewhat, as more capital and labour will produce more land intensive products even with land unchanged. But the production possibilities curve grows mainly to the right. By 1920 the production possibilities curve is fairly balanced on the scales shown. By 1950, it is skewed in favour of labour/capital intensive products in place of its original skewness in the opposite direction.

The dotted line, $P-P'$, represents the locus of points of tangency to the successive production possibilities curves, where production has taken place. $C-C'$ signifies the path of consumption. To the left of the

intersection *i.e.* prior to about 1920, land intensive products were exported and labour/capital intensive products imported. After 1920, when the curves intersect, the trade position was reversed. The United States exported labour/capital intensive products and imported the products of land.

This representation is purely schematic. It departs from reality in a hundred ways—two goods, constant technology, a fixed factor, incomplete specialization, and so forth. Problems of defining land intensive products are quite complicated. Still, the demonstration has validity in a very broad sense and helps to illustrate how comparative advantages change with factor growth.¹

TECHNOLOGICAL CHANGE—Making old goods more cheaply.

Production functions can change so that the same factor combination can produce more goods than before or the technological change can be biased in such a way as to save more of one factor than the other. Thus, technological efficiency can result in lower price and consequently in reduced terms of trade. However, a biased growth in the export good which augments the abundant factor, may lead to export biased growth, in fact to ultra export biased growth. Similarly the technological growth in the import competing good which augments the scarce factor will lead to ultra import-biased growth. There may be several intermediate cases.

Factor growth and Technological Change.

Factor growth and technological change may occur simultaneously or quasi-simultaneously in the real world to maintain a comparative advantage in a given commodity. The U.S. was losing its comparative advantage in agriculture because of increase in the price of labour. However, during the course of World War II a quasi revolution occurred and agriculture was thoroughly mechanized. This led to exports of agricultural products, though these were capital intensive in a capital intensive country.

Changes in technology—new goods.

'Technology is not the same all over the world' was proved by a study of Irving Kravis. He found that in every country the exporting industries were those which paid the highest wage rates, what a country produced and exported, he decided, was what it had "available", *i.e.*, the goods which its entrepreneurs and innovators developed. Linder suggested that besides having entrepreneurs and innovators, the country must have a broad local market. There must be a body of consumers in the home country interested in and able to buy a new product before manufacturers can develop the skills to make it cheaply and sell it abroad. This has been called the "spill-over" theory in which exports grow out of domestic production. It applies only to manufactures, not to primary products. It asserts that few products develop directly in the world trade without

1. Charles P. Kindleberger, *International Economics* (Homewood, Richard D. Irwin Co. 1968, pp. 57—62).

having achieved importance in a domestic market. Thus much trade in manufactures is based not on factor proportions but on a so-called technological gap.

Several studies have been made where the U.S. pioneered in many innovations, exported the products concerned, but did not continue to export when technology was widely known. Raymond Vernon identifies three stages in the life of a commodity, *i.e.* new, then maturing (when it spreads to other industrialised countries), and finally standardized. In the United States it is felt that many of her exports have a high technological content and that many of these exports diminish or disappear when the technological lead of the United States narrows or is lost. It is yet to be clarified whether technological gap is simply a management advantage or a technological one. "Whatever the outcome of this discussion, however, it lends realism to international trade to get away from the simple assumption of a given state of the arts, applied world wide, and to recognize that innovation produces trade even though that trade may disappear or be reversed when the technology has spread."¹

Suggested Readings

- | | |
|-----------------------------------|---|
| 1. C.P. Kindleberger | : Foreign Trade and the National Economy. |
| 2. H.G. Johnson | : Money, Trade and Growth. |
| 3. C.P. Kindleberger | : International Economics. |
| 4. American Economic Association. | : Readings in International Economics. |

1. Charles P. Kindleberger, *International Economics*, (Homewood, Richard D. Irwin, 1968, p. 67).

TRADE AND GROWTH IN DEVELOPING ECONOMIES

Q. How can you justify the double standard of an under-developed country when it wants free trade to increase its imports and protection to decrease its imports. *Or*

Q. "The theory of international trade was not worked out to explain the reality of underdevelopment and the need for development." Discuss. *Or*

Q. "The theory of international trade was never developed to comprehend the reality of great and growing international economic inequalities and of the dynamic process of development and under development." (Myrdal). Do you agree?

Ans. The classical theory of international trade has shown a remarkable capacity to absorb modifications as required by advances in general economic theory and by the exigencies of public policy issues. Yet, in spite of its substantial evolution from Hume and Ricardo through Marshall, Edge Worth and Taussig, to Vineer and Haberler the traditional theory still remains an analysis of full static equilibrium with respect to domestic market assumptions, and is concerned most directly with rich advanced economies. In contrast general economic theory has sought increasingly to incorporate long period dynamic analysis, and the most pressing international economic problems now involve the acceleration of development in poor countries.¹

Followers of the classical tradition have long been uneasy about Professor William's criticism that "The relation of international trade to the development of new resources and productive forces is a more significant part of the explanation of the present status of nations, of incomes, prices, well being, than is the cross-section value analysis of the classical economists, with its assumptions of given quanta of productive factors already existent and employed."

Many would subscribe to Professor Nurkse's moderate statement. "The case for international specialisation is firmly based on considerations

1. Gerald M. Meir, International Trade and Development, Harper and Row; New York, 1963, pp 1-3.

of economic efficiency. The world is not rich enough to be able to despise efficiency. The optimal pattern of specialisation is governed by the principle of comparative advantage. This principle remains as valid today as it was in Ricardo's time. And yet there is same question whether it alone can give us the guidance needed by countries whose dominant and deliberate aim is economic development...If one asks what help it offers here and now to low-income countries in search of development, the answer is not altogether clear."

Gunnar Myrdal feels, "...under-developed countries need international special consideration because of the very fact that they are under-developed, extremely poor, and encounter great difficulties in their attempts to develop." "The theory of international trade was not worked out to explain the reality of under-development and the need for development. One might say, rather, that this imposing structure of abstract reasoning (classical theory) had almost the opposite purpose, that of explaining away the international equality problem. International inequalities of income have been increasing for a long time and are still increasing. Yet the theory of international trade clung to the concept that international trade initiates a tendency towards a gradual equalization of incomes as among different countries under assumptions that should stand out as obviously unrealistic and against all experience."¹

DEVELOPMENT THROUGH TRADE

Q. When would you consider a departure from free trade justifiable for a developed economy? Will it make any difference if you were concerned with an underdeveloped country? *Or*

Is there a conflict between the gains from trade and the gains from growth? Is there any reconciliation possible between the two? *Or*

How far, traditionally, international trade has influenced the potential for development?

Ans. Is there a conflict between the gains from trade and the gains from growth? Can foreign trade have a propulsive role in the development of a country? Or on the contrary, are the dictates of international trade incompatible with the requirements for accelerated development? To the extent that classical and neo-classical economists offered a judgment on this problem, they hold that foreign trade could make an impressive contribution to a country's development. Trade was considered to be not simply a device for achieving productive efficiency; it was also an engine of growth.

List, Lenin and Manoilescu and others have dissented from this optimistic view. At the theoretical level it is frequently contended that the conclusions from the static equilibrium analysis of traditional trade theory are irrelevant for interpreting the problems of development which are

1. Gunnar Myrdal, *The Challenge of World Poverty*, Penguin Books Ltd., England, 1970, pp. 272—73.

inherently dynamic. And in the historical context it is argued that international trade has actually operated as a mechanism of international inequality—widening the gap in the levels of living between rich and poor countries. The policy implications of these theoretical and historical arguments are that, even if there is some cost in sacrificing the gains from international specialisation, the poor countries will still realize a net gain by way of inducing a higher rate of development if they followed policies of import substitution and deliberate industrialisation. It is maintained that, instead of waiting for the transmission of development through trade, the poor countries would be better off if they directed their own development towards an expansion of output for their domestic markets. Just as the theory of the “big push” for a domestic economy minimizes the importance of fulfilling marginal conditions in favour of achieving a series of big discontinuous “jumps”, so too it is claimed, in terms of the international economy, that the gain from trade are of only secondary significance compared with the achievements of the gains from growth.

The problem of the gains from trade versus the gains from growth can be stated as follows: When a country specializes according to its comparative advantage and trades at the international exchange ratio, it gains an increase in real income. This gain is tantamount to an outward shift in the country's production frontier, even if the economy operates under the constraints of fixed amounts of resources and unchanged techniques of production. But there still remains the question of whether some other pattern of resource allocation, different from that governed by comparative advantage, might not lead to an even greater outward shift in the production frontier over time. Although the resource allocation associated with trade might conform to requirements for productive efficiency in a single period, it is possible that another initial allocation would conform more closely to the multiperiod, not merely single period, requirements for productive efficiency. In other words, there may be a domestic misallocation of resources, from the stand point of maximizing output over time, even though there is optimal allocation from the stand point of achieving the gains from trade in each single period.

Such a possible conflict between the gains from trade and the gains from growth was not envisaged in traditional trade theory. However, there was some recognition of the dynamic and growth-transmitting aspect of trade above and beyond the static gains from international specialisation¹. As such, the gains from trade were entirely consistent with the gains from growth; indeed the latter could be expected to increase *pari passu* with the extension of foreign trade.

John Stuart Mill was especially definite on this. Trade, according to comparative advantage, results in a, “more efficient employment of the productive forces of the world”. Apart from this direct advantage, indirect benefits accrue. One such is the tendency of even extension of the market to improve the processes of production. Secondly, people

1. David Ricardo, J.S. Mill, Alfred Marshall and Taussig held such views.

become acquainted with new objects (after foreign trade) and thereby help in the industrial revolution as hard work, and saving habit is encouraged in the less developed countries.

According to Mill, trade benefits the less developed country through, "the introduction of foreign arts, which raise the returns derivable from additional capital to a rate corresponding to the low strength of the desire of accumulation ; and the importation of foreign capital which renders the increase of production no longer exclusively dependent on the thrift or providence of the inhabitants themselves, while it places before them a stimulating example, and by instilling new ideas and breaking the chain of habit, if not by improving the actual conditions of the population, tends to create in them new wants, increased ambitions and greater thought for future."¹

This conception of the impact of trade emphasizes the supply side of developmental process—the opportunity that trade gives a poor country to remove domestic shortages and to overcome the diseconomies of the small size of its domestic market. Of major benefit is the opportunity that trade offers for the exchange of goods with less growth potential for good with more growth potential, thereby quickening the progress that results from a given effort on the savings side.² An obvious example is the opportunity to import capital goods and materials required for developmental purposes. Perhaps of even more value than the direct importation of material goods is the fundamental "educative effect" of trade. A deficiency of knowledge is a more pervasive handicap to development than is the scarcity of any other factor. By providing the opportunity to learn from the achievements and failures of the more advanced countries, and by facilitating selective borrowing and adaptation, foreign trade can help considerably in speeding up poor country's development.

Classical economists also noted the effects of trade on the domestic factor supply, especially on capital accumulation. The capacity to save increases as real income rises through the more efficient resource allocation associated with international trade. And the stimulus to investment is strengthened by the realization of increasing returns in the wider markets that overseas trade provides. Further, by allowing economies of large scale production, the access to foreign markets makes it profitable to adopt more advanced techniques of production which require more capital ; the opportunities for the productive investment of capital are then greater than they would be if the market were limited only to the small size of the home market.³

For these several reasons, the traditional conclusion has been that

1. J.S. Mill, *Principles of Political Economy*, London, 1848, Book I, Chap. XIII, Section I.

2. J.R. Hicks, *Essays in World Economics*, Oxford University Press, 1959, p. 132.

3. J.R. Hicks, *Essays in World Economics*, Oxford University Press, 1959, pp. 183—185.

international trade stimulates a country's development. Above and beyond the static gains that result from the more efficient resource allocation with given production function, international trade also transforms existing production functions and induces outward shifts in the production frontier. The dynamic benefits of trade can be summarized as meaning, in analytical term, that a movement along the production frontier in accordance with the pre-existing comparative cost situation will tend to push up and out the production frontiers.¹ According to him four dynamic benefits follow from trade the provision of the material means of development in the form of capital goods, machinery and raw and semifinished materials, access to technological knowledge, skills managerial talents and entrepreneurship, the receipt of capital through international investment; and the stimulating effect of competition. Thus when they are properly interpreted in their dynamic sense, the gains from trade do not result simply from once-over change in resource allocation, but are continually merging with the gains from growth. And if trade increases the capacity for development, then the larger the volume of trade, the greater should be the potential for development.

CRITICISM OF THE CLASSICAL APPROACH AND ITS APPLICABILITY TO DEVELOPING COUNTRIES

Q. (i) Why has not the classical doctrine of international trade applied to the less developed countries ?

(ii) How do you explain the little growth resulting from international trade in less developed countries ?

(iii) "Thus in the historical context, trade has served as a mechanism of international inequality ; increasing the gap between the have and have nots." Discuss.

Ans. International trade did have a propulsive role in the development of a number of countries that are now among the richest in the world. In the case of Britain, development was fostered by the export trade in woollen manufactures and cotton textiles ; for Sweden, it was the timber trade ; for Denmark, dairy produce ; Canada, wheat ; Australia, wheat and wool ; Switzerland, lace-making and clock-making; Japan, silk. In many historical cases of successful development the importance of international trade is clearly confirmed and not only for countries that exported industrial products, but also for primary product exporters.

But it is quite misleading to say that trade relation based on static comparative advantage resulted into the economic development of the less developed countries. This point of view is presented by Mr Nandwani in the following way : Specialiation in trade was often determined by the colonial power and much in accordance with the needs of that country and not according to natural advantage. They created the so-called capitalistic enclaves within each country and there existed a complete

1. Gottfried Haberler ; International trade and Economic Development, National Bank of Egypt, 1959, pp. 10—15.

alliance between the foreign power and the local elite. It hardly took any steps to improve the socio-economic structure of the dependent country. So the advantages of trade were least transmitted into the economic patterns of the developing countries and even the demand for primary products continued declining in the world market. It gave the most unbalanced nature to the economies of these countries turning them into monoculture economies. Thus the economic structure of these countries became lopsided and dependent only on the export of one or two commodities which gave rise to good deal of instability.¹

The less developed countries suffer due to non-inequitable exchange between them and the developed countries. It is so because the decreasing cost of production in the developed countries as a result of higher technological progress and advance in productivity is not reflected in the prices while trading with the developing countries. Moreover, the prices of primary products are set rather at a base minimum because of their competitive nature and declining demand. Thirdly, the developing countries have inelastic imports, consisting of machinery and food-stuffs which are a must for them at any price : while the imports of the developed countries from the developing countries have a more elastic demand. Sometimes, as a token of good will, they just oblige the developing countries by importing their products. Under the circumstances unfavourable terms of trade are inevitable. Thus in the historical context, trade has served as a mechanism of international inequality, increasing the gap between the have and the have-nots.

The gains from trade were not allowed to be transmitted to the economies of poor countries. Nor the foreign trade resulted in the more efficient employment of productive forces. Even the secondary benefits of larger production, resulting into economies of scale did not materialize as these economies never reached the stage of enlarged production and if they did, these advantages were transmitted to the developed countries because of the strong bargaining position resulting out of monopolistic and oligopsolistic markets for the products of developing countries. The dynamic force of international trade were not allowed to play a free role in the less developed countries, with the result that they could not widen the area of their market, enlarge the division of labour, and permit the greater use of machinery through greater technological know how and thus lagged behind in the matter of increase in productivity.

Kindleberger also is of the same view. He argues in the following way : This (the little growth from trade in developing countries) is partly because of the world environment, in which the terms of trade are believed to turn systematically against the less developed countries ; partly it is the result of the conditions in the countries themselves. On the first score, the world environment, it is maintained that the developed countries grow with anti-trade biased demand and anti-trade biased factor growth

1. S. C. Nandwani, *Trade Dilemma, of Developing Countries*, Cosmopolitan Publishing House, Delhi, 1968 pp. 50—51.

and technological change. In addition, monopolistic competition among the developed countries and more competitive conditions of production in the less developed hurt the terms of trade of the latter. On the second score—conditions in the developing countries—their capacity to take advantage of the opportunities for growth presented to trade is restricted by inability to transform, *i.e.*, to shift resources where they can earn the highest return : by the fact that factor and good prices do not reflect social marginal productivities, and by a heavy dependence on imports of intermediate and capital goods for growth, and by utilization of their resources at a time when an export-maximum exists.¹

Suggested Readings

1. C.P. Kindleberger : International Economics.
2. G.M. Meier : International Trade and Development.
3. U.N. : Towards a New Trade Policy for Development.
4. S.B. Linder : Trade and Trade Policy for Development
5. American Economic Association : Readings in International Economics.
6. S.C. Nandwani : Trade Dilemma of Developing Countries.

1. Charles, P. Kindleberger, International Economics, Richardo, D. Irwin In. Homewood, 1968, pp. 84-85.

TRANSPORT COSTS AND LOCATION THEORY

Q. (i) Critically examine the impact of the introduction of transport costs upon the comparative costs doctrine.

(ii) "The introduction of transport costs partially nullifies the price-equalising effects of international trade." Discuss.

(iii) Review briefly the three broad types of effects of transport costs upon the location of Industry.

Ans. The traditional theory of comparative cost is based upon the assumption that no transfer costs of any kind exist, so that prices of internationally traded goods are equalized in the two countries. The classical theory treats all countries as mere points which are so close to one another that transfer takes place in costless fashion. This supposition hardly accords with the facts of the case. Transport costs do exist and must be reckoned with in the context of international trade.

The introduction of transport costs into our analysis creates new complication, but does not in any way invalidate the doctrine of comparative advantage. Their existence only requires us to make two important qualifications, first with respect to prices in international trade, and second with respect to the location of the industry.

Effects of Transport Costs on Prices and Trade

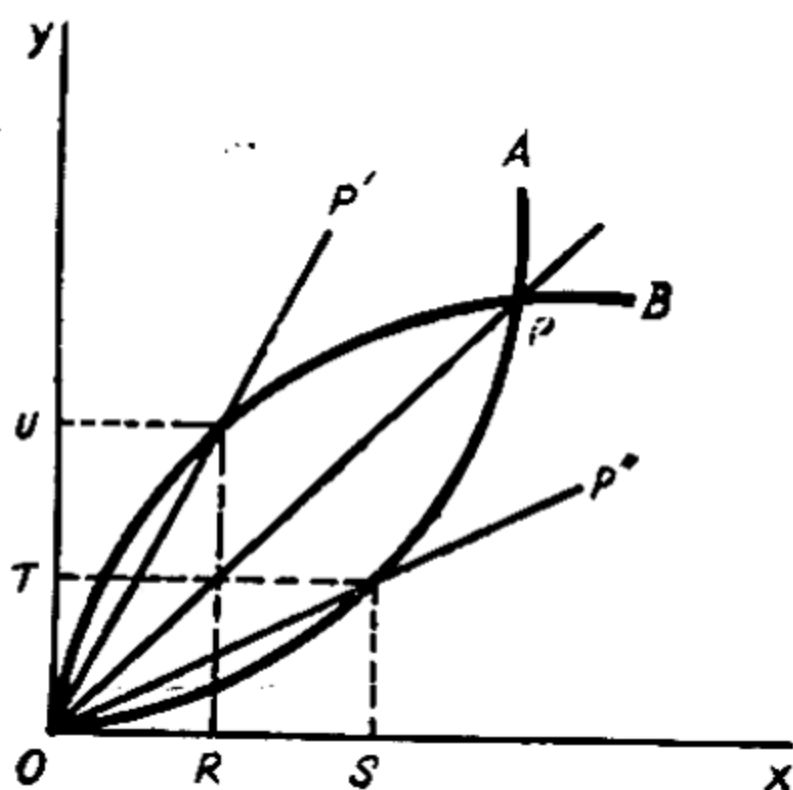
The existence of transport costs prevent the complete equalisation of prices that trade would otherwise bring about. Because of these costs, the import goods becomes more expensive in both the countries and the export goods less valuable. The implications of this can be portrayed diagrammatically.

General Equilibrium with Transport Costs

In the figure given on page 55 OA is country (A's) offer curve of X and OB is country (B's) offer curve of Y. In the absence of transport costs OP is the price in both countries. With transport costs, the price ratios in the two countries must differ. OP' becomes the price ratio in country (B) and OP'', the price ratio in country (A).

At OP', country (B) is willing to offer OU of Y against OR of X. At OP'', country A is willing to offer OS of X for OT of Y. The difference between what (B) gets at the price OP' and what A is willing to offer

in terms of X at the price OP'' takes the form of transport. Thus the introduction of transport costs moves us to a three commodity diagram in the sense that country (A) offers X for Y and transport, and country (B)



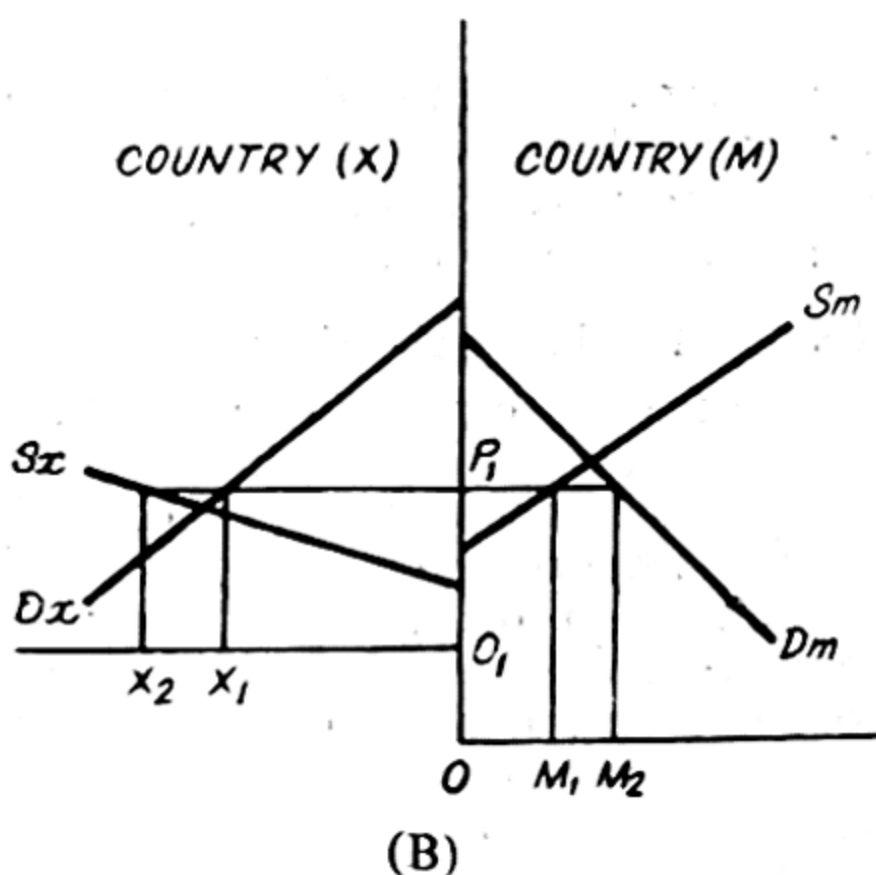
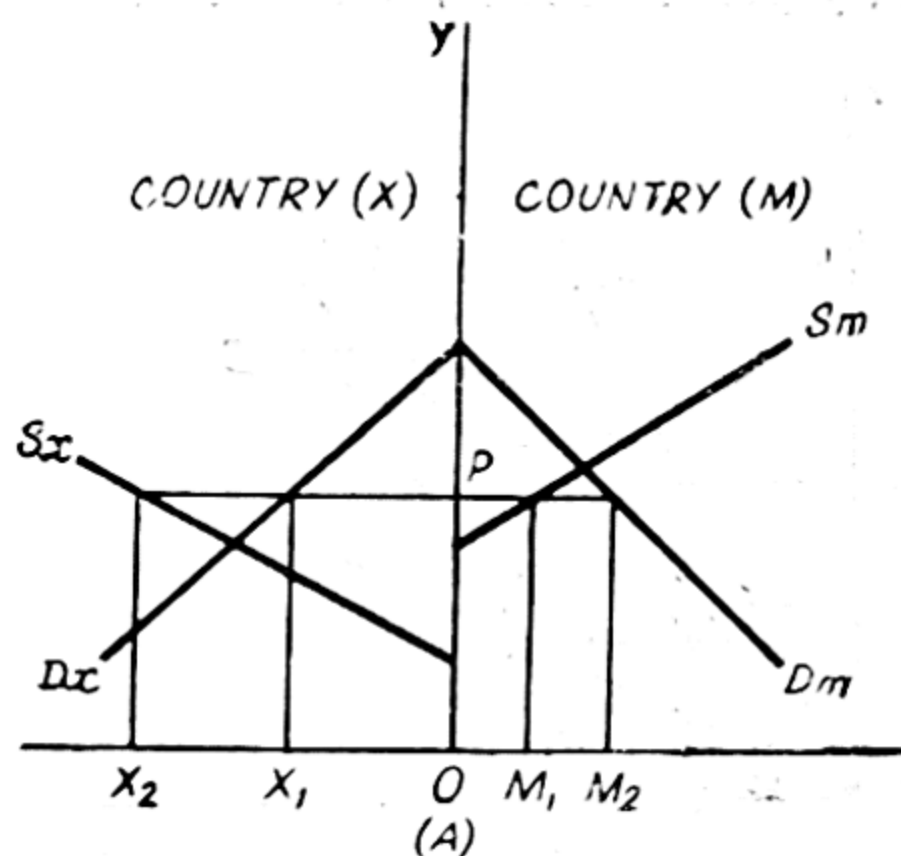
offers Y for X and transport. In this diagram, transport costs are expressed in terms of the traded goods themselves ; such costs require the price lines in the two countries to differ in slope by an amount representing transport costs in terms of the two goods.

TRANSPORT COSTS—In Partial Equilibrium

The effects of transport costs can be more satisfactorily expressed in terms of partial equilibrium analysis. In figure (A) price of wheat is measured on the vertical axis common to both countries. The demand and supply curves for the importing country (M) are shown in the right hand-side of the diagram, with quantities measured from left to right starting with O . The situation of the exporting country (X) is described in the left hand side of the diagram, with quantities read from O to the left. In isolation, each country would produce and consume at the price indicated by the intersection of its individual demand and supply curves. With the opening of trade and in the absence of transport costs, (X) will export wheat to (M), since the supply curve of the former starts at a lower point on the cost-price axis than that of the latter and remains lower for corresponding outputs. Equilibrium is established at the price OP , common to both countries ; at this price country (X) exports X_1X_2 of wheat equal to country (M) imports (M_1M_2 of wheat). The price of wheat is now higher in (X) and lower in M than it would have been in the absence of trade.

Transport costs can now be introduced by adding it to the production costs of wheat. This can be done by raising the exporting country's entire half of the diagram in Figure (B) given on page 55 by the amount of transport cost. Figure shows this by raising the left side of this diagram by the distance OO' , the transport cost to be borne out by the importing

country. The wheat price in M is now OP_1 which is higher than the price O_1P_1 in X by the amount of the transport cost OO_1 .



It should be noted that the price in M does not rise by the full amount of the transport cost. The rise in wheat price in (M) causes demand to shrink, so that (M's) total purchases OM_2 are smaller than before. This reduction in demand lowers production in X. The distance OX_2 (fig. A) is smaller than OX_2 (figure B); production has moved along the supply curve Sx to a lower point, where marginal cost of O_1P_1 is less than before (OP in fig. A). The transport is added to an export price that is lower than before; it means that the price in M rises by less than the amount of transport costs.

At the lower price in (X) domestic consumption O_1X_1 is greater than before, and at the higher price in (M), domestic production expands (OM_1 in Fig. B is greater than OM_1 in Fig. A). All this means that (M's) imports have now declined. The new distance M_1M_2 (M's imports = X's

exports, X_1X_2) in Figure (B) is less than the original distance M_1M_2 in Fig. (A).

Thus transport costs make prices in the importing country higher than in the exporting country. That is "the introduction of transport costs partially nullifies the price equalising effects of international trade." At the same time the volume of trade is reduced. Only those goods that can bear the transport costs and still can be obtained cheaper from abroad will be imported; all others will be produced locally. No longer comparative advantage alone determines what goods are exported and imported; a good will be traded, provided price differences in the two countries before trade are wider than transport costs. Trade will not take place, if transport costs are wider than price differentials in the absence of trade. This explains why many goods and services do not move in international trade and why international specialisation is reduced substantially. By affording 'natural protection', transport costs bring into being a wide range of home produced goods.

DIFFERENTIAL EFFECTS OF TRANSPORT COSTS

Treatment of transport costs would be comparatively simple if they varied precisely either with weight or bulk, or distance. Unfortunately, this is not the case. They vary widely from commodity to commodity, the degree of variation being influenced by many complex factors—weight, bulk, value, perishability of the good, method of transport and distance. Moreover, transport services are unavoidably joint products; the same resources (such as a railway's roadbed) are used simultaneously to carry various commodities. It is, therefore, not always possible to attribute specifically to a single commodity any of the large overhead costs of transport. Indeed, the majority of transport costs are jointly incurred; their allocation to the various goods becomes often discretionary. There are other complexities. Of particular importance is the fact that all goods require raw materials for their production, and that transport charges are generally lower on raw materials than on finished products. Moreover, these raw materials, in course of their processing, may either lose weight or gain in weight. These complexities make for differential effects of transport costs.

TRANSPORT COSTS AND LOCALISATION

The complexities associated with transport costs make it difficult to determine the most economical point at which to locate production. No simple generalisation on this issue is possible. Nonetheless, one can distinguish three broad types of effects of transport costs on the location of industry. Thus industries may be (i) materials-oriented (or supply-oriented), (ii) market-oriented, (iii) foot-loose (or neutral in their orientation).

Supply-Oriented Industries: There are those industries in which the industrial process tends to be located near the source of the major materials or fuel. If these are located elsewhere, the cost of transporting

the raw material (or fuel) to the market will exceed the costs of transporting the finished goods. Generally, production supply-oriented industries involves weight-losing processes. An example in point is timber manufacturing which takes place near the timber stands.

Market-Oriented Industries. Just as weight-losing processes tend to be located near the sources of raw-materials or fuel, so processes which add weight or bulk to the product are attracted to the market in order to minimize transport costs. Automobile assembly is of this character. Perishable commodities are also market-oriented. In general, the early stages of production are likely to be supply-oriented and the later stages tend to be market-oriented.

Foot-loose Industries. A number of industries are neutral or indifferent to the pull of supply or of the market. The reason may be that transport costs are relatively insignificant; or the changes of weight and bulk in this course of processing are unimportant. In these cases, location is likely to be at either end of the transport chain.

Since transport costs exert little influence on foot-loose industries, other elements, such as processing costs, factor endowments will be decisive in determining industrial location. "It is in these industries—textile, matches, oil refining, etc.—that the theory of comparative costs in its undiluted form operates to determine what a country exports and imports in the absence of direct intervention by the State in the form of tariff policy. By the same token,.....it is in these foot loose industries that commercial policy can most effectively distort the operation of the law of comparative cost."¹

Suggested References

1. C. P. Kindleberger : International Economics.

1. Charles, P. Kindleberger, International Economics. Richard, D. Irwing Inc 1968, Homewood, p. 99.

BALANCE OF PAYMENTS—MULTIPLIER ANALYSIS

Q. "You can no more define equilibrium in international trade than you can define a pretty girl, but you can recognize one when you meet one."
—Per Jacobsson, 1949

Distinguish between the concept of balance of trade and balance of payments.

"Balance of payment on current account is different from balance of payment on capital account". Classify.

Ans. Balance of Trade

Balance of trade refers to the value of imports and exports of commodities only i.e., visible items only. Exports may exceed the imports of goods and the country may enjoy a favourable balance of trade. Excess of imports over exports of goods leads to unfavourable balance of trade. In other words, the balance of trade need not balance itself.

2. Balance of Payments : Current Account

Balance of payments includes balance of trade plus invisible items as shipping, banking, insurance, tourist traffic, interest on investments. Thus it is more comprehensive than balance of trade in the sense that while the latter consists only of visible items, the former adds invisible items to visible items. The balance of payments on current account need not balance itself. Thus favourable or unfavourable balance of payments on current account are possible.

3. Balance of Payments : Capital account

The capital account deals with loans from or to foreigners, capital repayments from or to foreigners and purchase of assets by or from foreigners. While the current account deals with payment for currently produced goods and services including also interest earned or paid on claims and also gifts and donations ; the capital account deals with payment of debts and claims. The current account of the balance of payments affects the level of national income directly, the capital account does not have such an effect directly ; it influences the volume of assets which a country holds. The capital account taken together with the current account will balance the balance of payment account of a country.

THE LEVEL OF INCOME AND THE BALANCE OF TRADE

Q. How can you explain the relationship between the level of income and activity in a country and its balance of trade?

How does the multiplier analysis apply to international trade?

Examine the impact of economic development and growth on the terms of trade.

Ans. A close relationship exists between the level of income and activity in a country and its balance of trade. Changes in the balance of trade affect the equilibrium level of income, the changes in the level of income affect the state of balance of trade. We make the following assumptions :

(i) Price levels, interest rates and quantities of fixed investment in each country are constant.

(ii) Unemployed resources exist in each country so that increased demand for the goods of a country gets reflected in increased output and activity and not in price rises.

(iii) Exchange rate between the country concerned and the rest of the world is constant i.e., the price with which one currency can be bought with other does not vary.

(iv) Prices of imported goods in terms of home currency in each country do not vary.

It is reasonable to consider that total value of exports are not influenced by the level of income in the country concerned. However, plans to buy imports are definitely affected by changes in the level of income. In this way the value of imports comes to depend upon level of activity and income in the country concerned. We measure the ratio between a change in plans to imports and a change in income by the concept of marginal propensity to import. If a rise in income of 100 leads (at current prices) to plans to purchase 10 more of imports, the marginal propensity to import is $\frac{10}{100} = \frac{1}{10}$ or 0.1.

Several consequences follow from the concept of marginal propensity to import :

(i) If the marginal propensity to import is greater than zero (normally it happens), a rise in the level of income raises imports while exports are constant and consequently results in a deterioration in the balance of trade. Similarly a rise in the level of income abroad raises that country's imports which means our exports are raised. Thus our balance of trade is improved.

(ii) Expenditure on imports is similar to expenditure on savings.

It does not lead to further increases of income at home. Like savings, it leaks out of the system and provides no direct impulse to a further round of expansion of the level of income.

(iii) Just as imports are parallel in their effects to savings, similarly exports are parallel in their effects to investment. Investment is determined autonomously, they are not dependent upon the level of income in the country. Similarly exports are determined by the level of income in other countries and not in the country concerned. In other words, changes in both investment and exports are autonomous. Besides a change in the level of exports induces a multiple change in the level of activity and income just as investment does. An increase in the demand for home-produced goods, which lead to increased income, for the producers of these goods and so to more expenditure by them; hence a multiplier expansion.

More generally, an improvement in the balance of trade of a country, whether as a result of increased exports or reduced imports arising from a shift of demand from imports to home goods, leads to a multiplier expansion of income. Similarly a deterioration in the balance of trade leads to a multiplier contraction.

The Foreign Trade Multiplier Without Foreign Repercussions

We assume that our country is so small in relation to the rest of world, that it does not influence the other country and therefore no appreciable effect is reflected back to our country. As we do in the analysis of the closed economy multiplier, we shall consider (i) the conditions that must be satisfied for a stable equilibrium level of income to exist, and (ii) the process by which economic conditions move from one equilibrium to another, after a disturbance.

As far as the accounts for a past period are concerned, the following identity must always be realized: realized savings plus realized imports equal realized investment plus realized exports. Reasons for the satisfying of this condition may be summed up in the following way:

$$\begin{aligned}\text{Income} &\equiv \text{Consumption of home goods} + \text{Imports} + \text{Savings} \\ \text{Out put} &\equiv \text{Consumption of home goods} + \text{Exports} + \text{Investment} \\ \text{Income} &\equiv \text{Output} \\ \therefore \text{Imports} + \text{Savings} &= \text{Exports} + \text{Investment} \\ \text{or } \text{Exports} - \text{Imports} &= \text{Savings} - \text{Investment}.\end{aligned}$$

The first identity describes the ways in which income has been spent; the second describes the various forms of output; the third states the necessary position that total income equals total output. The final statement (that realized exports minus realized imports necessarily equals realized savings minus realized investment) can be seen in another way. The surplus of realized exports over imports (the balance of trade surplus) is equal to net investment abroad—i.e. to additional net claims against

foreigners and fixed assets held overseas. The surplus of savings over investment is the difference between total additional wealth owned by residents of our country, and total additional fixed wealth at home plus additional holdings of stocks of goods at home, that part of additional wealth not held at home must be held abroad, whether as real wealth or as claims against foreigners ; this is quite obvious.

Returning to the other form (that imports plus saving equals exports plus investment), it is clear that the condition necessarily applies for realized magnitudes, but by no means necessarily for plans. If planned purchases of imports plus planned savings do not equal planned purchases of exports plus planned investment for some period, then some plans will not be precisely realized. We assume that home residents plan to purchase imports and foreigners plan to purchase exports are always realized. Consequently, the failure to realize plans impinges on savings and investment.¹

When all plans are realized, stable equilibrium emerges. If plans are not realized, they are altered and thus lead to changes in the level of incomes. An equilibrium level of income is possible only if saving plus import plans equal investment plus export plans. The equilibrium level, therefore, depends upon the marginal propensity to save (which determines the level of planned savings), the marginal propensity to import (which determines the level of planned imports), the level of fixed investment firms wish to carry out, and the value of exports foreigners wish to buy.

The foreign trade multiplier without repercussions tells us what will be the effect of a change in the original level of investment or exports upon the level of income. We assume that all imports are directly used at home so that exports do not include any imported materials. A rise in investment or exports leads to a multifold increase in the equilibrium level of incomes, the increase depending upon the marginal propensity to save plus the marginal propensity to import. The multiplier is the inverse of marginal propensity to save plus the marginal propensity to import. The larger the savings and imports, the greater are the total leakages and the smaller is the multiplier.

We assumed in the above analysis that the whole of additional investment expenditure is used for purchasing home produced goods ; the rise in the plans to imports starts only when consumer's expenditure rises as a result of induced rises in income. If, however, we assume that some of additional investment expenditure is used for buying foreign goods, the stimulation to expansion at home is less and equilibrium rise in income is proportionately less.

1. A.C.L. Day, *Outline of Monetary Economics* (Oxford University Press, London, 1957, pp. 375—376).

The Foreign Trade Multiplier, With Foreign Repercussions.

We assume that our country is not so small and therefore affects the final position. We assume that a rise in investment at home initiates the expansionary process, which leads to increased imports. These increased imports imply an increase in exports by the foreign country leading to a higher level of income in that country. This higher level of income leads to more imports which raise mean increased exports for the home country. This again leads to an expansionary process resulting in an increased level of income and activity in the home country.

The conditions must be satisfied in both the countries as distinguished from a single country in the discussion on foreign trade multiplier without foreign repercussion. In each country planned savings plus planned investment must equal planned investment plus exports. Moreover, imports of one country must necessarily be equal to the exports of the other country.

The equilibrium level of incomes in both the countries will be higher than the original level was disturbed by an increase in investment. The balance of trade, however, can never be more favourable and is usually less favourable to the home country than it was originally. Moreover, if in either country the marginal propensities to save and to import are small, the change in the level of income will be relatively large. The reason is that leakages into savings and imports are small, any given rise in demand for goods leads to a bigger purely internal sequence of expansion. If the leakages into savings and imports are rather large at home and are rather small to the foreign country, the foreign country may have a greater rise in equilibrium level of income. Usually the home country registers a greater rise in income when the initiating impulse operates here. Finally the rise in the level of incomes abroad is reflected back to cause further expansion. This expansion through reflection from abroad will be larger, the larger is the foreigners' reflection ratio. This is the ratio of the foreigners' marginal propensity to import to his marginal propensity to save. If the MPI is relatively large and the MPS relatively small in the foreign country, then most of the leakages from internal expenditure in the foreign country benefit the home country.

Other Initiating Changes—A change in tastes.

Earlier we assumed a change in the level of investment in one of the countries. Now, we assume that the initiating change is a switch in demand between home goods and foreign goods. The process in achieving the equilibrium is the same *i.e.*, change continues in each country for as long as the plans of different transactors are inconsistent, and ends when planned saving plus imports equal planned investment plus exports in each country.

The change lies in the proximate effect of the initiating change on the demand for the goods of both countries. However, the effects are opposite. In one country demand expands, in the other it contracts. Expansion

in the country's demand because of increased level of living increase its imports and in this way prevent the contraction in the other country. Similarly the other country with reduced level of income and consequently reduced imports limits the expansion going on in the other country. In the final equilibrium position, the country with improvement in the balance of trade because of a change in tastes always finds itself with a higher level of output initially and the other country always finishes with a lower level. The mutual interference between opposing changes can cancel out but not reverse the changes.

The effect on the balance of trade is quite obvious. The induced expansion in the country with an improved balance of trade increases its imports and wipes out some of the improvement in the balance of trade. Similarly the induced contraction in the other country reduces its imports and wipes out some of the deterioration in its balance of trade.¹ These effects will be greater, the bigger are the changes in imports as a result of a given change in income and the larger the changes in incomes. This happens when the marginal propensities to import are larger and the marginal propensities to save are smaller.

The determinants of the new equilibrium level of income are ; (i) the size of the marginal propensities to save and imports ; (ii) the size of the reflection ratio. The change in level of output in either country will be greater, the smaller is the other country's reflection ratio ; a small reflection ratio means that external forces only wipe out a small part of the internal changes induced in either country. The small reflection ratio occurs when the other country's marginal propensity to save is large compared with its marginal propensity to import.

BALANCE OF TRADE IN THE FULL EMPLOYMENT ZONE

In conditions of near or full employment even if prices are constant, extra expenditure is increasing directed towards imports. This happens when no extra resources are available at home but easily available abroad. The marginal propensity to import happens to be high consequently the increased presence of demand at home has a large adverse effect on the balance of trade.

Secondly, exports are affected through delivery dates. Exports order cannot be satisfied on the full employment zone, so order books lengthen and actual exports do not expand as fast as the foreigners demand expands. Sometime this leads the foreigners to switch to other countries. In both cases exports tend to fall of or not to rise as much as the foreign trade multiplier may suggest, when the level of activity moves into the full employment zone even when price rises are small enough to be disregarded. In other words, a rise in the level freight in full employment zone leads to strong pressure on the balance of trade through its effects on imports and exports as well.

1. A.C.L. Day, Outline of Monetary Economics (London, Oxford University Press 1957, p. 381).

EFFECTS OF ECONOMIC DEVELOPMENT AND GROWTH ON THE TERMS OF TRADE

Economic growth may be defined as increasing income per head over time. Assuming that growth does not lead to a change in taste and that it moves the production possibilities curve outwards. If terms of trade remain unchanged, production and consumption both would increase. If the terms of trade improve, consumption would be on a still higher level. If the terms of trade deteriorate, consumption is pushed below. However, so long as the gains from growth exceed the losses from worsening terms of trade, the country will find itself better off after growth than before. If the terms of trade deteriorate sufficiently, real income would decline and consumption would be at a lower level. The growth in output is offset by the worsened terms of trade. This type of situation has been termed by Bhagwati as 'immiserising growth'.

The direction of change of the terms of trade with growth will be determined by what happens to the net demand for imports. Growth may result in increased demand for import and it may also lead to increased production of importables in the growing country. It will be the net effect of these demand and supply factors which determine the direction in which terms of trade move. These forces have been analysed in terms of output elasticity of demand and output elasticity of supply. Output elasticity of demand (O E D) is the percentage change in consumption of importables divided by the percentage change in the total output. Output elasticity of supply (O E S) is the percentage change in production of importables divided by percentage change in total output. Both are measured at constant relative commodity prices.

The degree of elasticity has been categorised in terms of trade biases :

- (If OED is equal to 1, this is a neutral demand effect.
- If OED is greater than 1, this is a protrade demand effect.
- If OED is less than 1, this is an antitrade demand effect.
- If OED is negative, this is an ultra antitrade demand effect.
- If OES is equal to 1, this is a neutral supply effect.
- If OES is greater than 1, this is an antitrade supply effect.
- If OES is less than 1, this is protrade supply effect.
- If OES is negative, this is an ultra protrade supply effect.

The net effect of growth is the combined result of production (supply) and consumption (demand) effect. However, a neutral demand effect combined with a neutral supply effect will cause an adverse shift in the term of trade (this is because there has been net rise in the demand for importables). The terms of trade will improve for the growing country only if the combined effect is ultra anti-trade biased (i.e. a net fall in the demand for importables).

A fuller treatment of the terms of trade effects of growth would require consideration of what happens (a) if growth is taking place in rest of the world, (b) if technical progress is non-neutral with respect to foreign trade. Kindleberger, Prebisch, Myrdal and others argue that theory and empirical data suggest that a downward trend in the terms of trade for the under-developed countries is probable and has, in fact, happened. On the other hand, Haberler, Meier, Morgan and others claim that empirical evidence is faulty and does not indicate a downward trend and that hypotheses on which such predictions are built are inadequate.

Suggested Readings

- | | |
|----------------------|---------------------------|
| 1. Fred Hirsch | : Money International |
| 2. C.P. Kindleberger | : International Economics |
| 3. A.C.L. Day | : Monetary Economics. |

THE BALANCE OF PAYMENTS

Q. Define clearly the concept of the balance of payments.

Why do we need to study the balance of payments ?

Distinguish between different definitions of the balance of payments and examine the problem arising out of such distinction.

Ans. Let us consider a few definitions :

KINDELBERGER. "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time. Kindelberger goes ahead and clarifies the concept of a 'resident' and 'economic transaction'. Besides including tourists, diplomats, military personnel, temporary migratory workers, the concept of resident also includes branches of domestic companies. The concept of 'resident' can and does vary from country to country. Similarly the concept of economic transaction involves the concept of payment for the transfer of title to assets from one party to another. However, entries may be made when payment may not be involved and yet the act may be regarded as international transaction. Here again the concept varies from country to country.

FRED HIRSCH. "A balance of payment, statement is an attempt to trace the financial transaction that a country has carried on beyond its borders. It is a statistical snap shot of the external aspect of the country's economy over the course of a given period of time, usually a year." Fred Hirsch also indicates what the balance of payments, concept does not do. For instance, it does not indicate why the financial transactions came about or what would have come about in the absence of particular policies or events.

WHY NEEDED ? The balance of payments statement serves the government of the country by providing it information about the international position of the country. It also helps the country to reach

decisions on monetary and fiscal policies and trade and payment questions. Monetary and fiscal policies need to be separated from trade and payment questions because the concept of balance of payments is put to different interpretations. It should be noted however that the balance of payments gives a partial view i.e. the external aspect of the country's economy. The external balance cannot be properly assessed without seeing what has happened to the underlying internal economy. In this way, it is less than a full reflection of a country's measure of performance or economic welfare.

ALWAYS BALANCED. In a sense the balance of payment is always balanced. The balance of payment records all payments made to foreigners and received from foreigners for the past year. As such the accounts must necessarily balance. The total amount paid by residents to foreigners must be equal to the total amount received by residents from foreigners. Full account for any past period must satisfy this rule. Therefore Balance of payments is always in balance. Whatever complications we add to the equality must be achieved. In other words, total receipts must equal total payments in the actual amounts of the past period.

Machlup distinguishes three types of balance of payments. The balance of payment may be : (A) a Market Balance, i.e. balance of supply and demand ; or (B) a Programme Balance i.e. a balance of hopes and desires ; or (C) an Accounting Balance, i.e. a balance of credit, and debits.

The market balance of payments is model of given situation in the foreign-exchange market, characterised by effective demand and supply of foreign exchange at the given exchange rates and at alternative hypothetical rates. This is an ex ante concept for use in the analysis of the foreign-exchange market, with major emphasis on the effects which changes of the exchange rate might have upon the amounts of exchange effectively demanded and supplied.

The programme of balance of payments is a statement of sources and uses of foreign funds, expected or planned, over a future period of one or more years, based upon the nation's capital and consumption requirements, and on a programme of meeting an excess of requirements over resources to foreign finance expected or sought. This also is an ex ante concept not for analysis but for use in planning, forecasting or negotiating, with major emphasis not on what is effectively demanded but on what is felt to be desirable with reference to some accepted standards.

The Accounting Balance of Payment is a record of all transactions, real and financial which have taken place over a past period of one or more years between the country's residents and residents of other countries, the record being kept in the form of double-entry book keeping, with each credit entry balanced by an offsetting debit entry, and vice-versa. This is an export concept based on statistical information and estimates for use chiefly in the description of past developments and perhaps also in the appraisal of the present position of one nation in relation to another.

DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

Meaning. The balance of payments deficit means that the country concerned is actually or potentially in balance of payment difficulties. These difficulties arise because the present course of event cannot continue indefinitely. If the present situation continues, insurmountable difficulties in the form of exhaustion of reserves, whether of gold, other foreign currency, or of borrowing power, will arise. In other words, running through an exhaustible stock of reserves may be regarded as equivalent to running in the balance of payment difficulties.

Deficits Machlup. According to Machlup the meaning of a deficit in the balance of payments is categorically different for his three different concepts of balance of payments. Moreover, within each concept the meaning of deficit is quite qualified and relative. We shall follow his analysis.

(a) **Deficit in the Market Balance of Payments** may be defined as an excess of dollar amounts effectively demanded at the given exchange rate by would-be-purchasers (who are not restricted by specially adopted or discretionary government control measures) over the dollar amounts supplied at that exchange rate by would-be-sellers (who are not motivated by a desire to support the exchange rate)". He introduces several classifications :

(i) The phrase "effectively demanded" is to mean that the would-be-buyers possess and are willing to part with the domestic money to pay for the foreign exchange.

(ii) The phrase "at the given exchange rate" will refer to the one actually prevailing, fixed and maintained by monetary authorities.

(iii) The phrase "not restricted by specially adopted or discretionary government control measures" is designed to impart flexibility to the definition.

(iv) The phrase "not motivated by a desire to support the exchange rate," is designed to separate the sales of foreign exchange out of monetary reserves and out of foreign stabilisation loans from the sales properly regarded as the "supply" of exchange in the market in which the balance between supply and demand is being analysed.

(v) Every supply and demand analysis has several time aspects. Disregarding temporary fluctuations, we can distinguish three kinds of cases from the point of view of long period deficits : (a) The excess demand is judged to be cyclical in character, that is associated with a particular phase of national or international trade cycle and hence likely to disappear in due time even without any special measures on the part of the governments concerned ; (b) the excess demand is judged to be associated structural or monetary factors expected to change before long in consequence of certain measures taken by the government or of certain developments afoot in the economy ; (c) the excess demand is judged to be associated with conditions not expected to change significantly in the foreseeable future.

(vi) There are different policies for dealing with a deficit to the market balance of payments. The excess demand for dollars can be reduced or removed by (a) altering the rate i.e., depreciating the domestic money; (b) sales of gold or dollars by the national or international monetary authorities; (c) rationing, administrative allocation, or similar discretionary restrictions of foreign exchange transactions; (d) monetary and fiscal measures reducing the money circulation and income flow of the country; (e) restrictive commercial policy; (f) persuading other countries to a more liberal commercial policy. Political compulsions dictate continual exchange depreciation as contrasted with other policies.

(vii) The market balance of payments refers to a given exchange rate under given condition of supply and demand. Changes in wage rates, interest rates, tariffs, production costs, consumer tastes, fiscal policy, credit policy etc. will alter the market conditions for foreign exchange so significantly that it is nonsense to predict the size of the excess demand for a time a year or two away.

(b) The Programme Balance of Payments.

“A dollar deficit in a country’s programme balance of payments may be defined as an excess of dollar amounts needed or desired for some specified purposes (assumed to be important with reference to some accepted standards) over the dollar amounts expected to become available from regular sources.” Following clarifications should be noted :—

(i) The phrase, “needed or desired” refers to the “requirements” computed by experts and based on what they regard as the nation’s needs or desires.

(ii) The phrase, “for some specified purposes” may refer to projections of import totals required to supplement domestic output in the achievement of certain levels of consumption and rates of development.

(iii) The phrase, “with reference to some accepted standards” indicates that the levels of domestic consumption and the rates of domestic capital formation are, in this context, matters of political judgment.

(iv) The phrase, “expected to become available from regular sources,” is to exclude the emergency sources.

(v) The programme balance of payments is always set up for a definite period of time, usually one year, sometimes two, three or four years.

(vi) The existing foreign exchange is relatively less essential for the programme balance of payments. It may possibly be a factor in the effective steering of productive resources for the attainment of the production and export targets set in the programme. However, it loses its importance if price and allocation controls are effective in the economy.

(vii) An increase in the money and real income will decrease a dollar deficit in the programme balance. The dollar gap is narrowed because people produce more, need fewer goods to import, and export more goods.

(viii) Exchange depreciation and deflation are of little relevance in dealing with a deficit in the programme balance of payments because relative prices are not of the essence in judging what the nation needs, desires or can do without. Import barriers and exchange restrictions are among the main instruments of implementing the programme, only for required imports are dollars made available. Exchange stabilisation (sale of dollars out of reserves of monetary authorities) is often a part of the programme of covering the deficit. The programme may seek foreign loans and grants for the larger position of the deficit, but draw on the dollar reserves of the nation to finance the rest.

(ix) The dollar deficit in the programme balance of payments is conditioned by the financing potentialities. The chief determinant of the deficit will be the realistic appraisal of how much foreign finance might possibly be obtainable (from other than regular sources).

(x) The programme balance of payments is a forecast of future developments. Even if the forecasts may not be true, they are significant when they are made. The importance of past trade balances in this context cannot be minimized.

The ex ante character of the programme balance of payments is self-evident, but to the extent to which hopes are fulfilled and targets attained, the export record of international transaction may fall with the programme.

(c) **The Accounting Balance of Payments.** The dollar deficit in a country's accounting balance of payments may be defined as an excess of dollar amounts entered on the debit side of certain accounts in the annual record of its international transactions over the dollar amounts entered on the credit side of the same accounts, the accounts being selected from the full, necessarily balancing statement in order to throw light upon problems connected with market or programme balance of payments. Certain clarifications are noted below :

1. The phrase, "certain accounts" serves as a recognition of the fact that a completed statement of all accounts cannot possibly show a credit or debit balance, while certain amounts can.

2. The phrase "debit side" stands here differently mentioned 'payments', 'imports', passive etc.

3. The "international transaction" does not refer to all transactions with foreigners.

4. The "credit side" stands for receipts, exports, active, decrease in gold and foreign assets etc.

5. The "accounts selected" refers to the various ideas or accounts at different times.

6. The phrase "in order to throw light" indicates the purpose, though it does not show the result as such

7. Time problem may be involved because these may occur within

a year a succession of deficits and surpluses in the market balance of payments.

8. The accounting balance of payments does not throw light upon the relationship between foreign exchange rates and the market balance of payments.

9. The accounting balance of payments cannot be used to indicate the market balance of payments. However, the international monetary fund, came out in this context with a new concept called "Compensatory official financing". It is provisionally defined as "the financing undertaken by the monetary authorities to provide exchange to cover a surplus or deficit in the rest of balance of payment." This definition singles out those operations which have the sole or primary purpose of providing foreign exchange in response to a situation that has arisen in the foreign exchange market. Much confusion has arisen over the interpretation, but probably this is because of the failure to distinguish between the market balance and the programme balance of payments in relation to compensatory official financing.

Conclusion. There is no necessary relationship between these deficits. One may witness the deficit in one with a surplus in the other senses. For example, a country with a deficit in its programme balance of payments may have a surplus in its market balance of payments provided the government continues to follow conservative fiscal policies. Similarly the possibility of a deficit in the programme balance and surplus in the accounting balance of payments may co-exist in a country receiving loans and investments from abroad while abstaining from expansionary domestic monetary policies. From this, it follows that much of the current talk about dollar shortage makes little sense. A country may have large effective demand for dollars—if the supply of domestic money is relatively large and the price of dollars relatively low. This does not indicate the urgency of the need for any dollar aid sought to increase the productivity of the nation's resources and to improve its plans of livings. And neither the urgent need, nor the effective demand for dollars is indicated by accounting records reflecting past financing decisions.

Suggested Readings

1. Fred Hirsch : Money International.
 2. C. P. Kindleberger : International Economics.
 3. F. Machlup : International Payments, Debts and Gold.
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EXTERNAL DISEQUILIBRIUM

✓
Q. Examine the causes which lead to an imbalance in the balance of payments.

What do you understand by fundamental disequilibrium? How would you correct it? Suggest suitable measures.

Examine the attempts to distinguish between different kinds of international disequilibrium.

Ans. The criticisms directed against the purchasing-power parity doctrine have highlighted the difficulty of measuring disequilibrium through comparing price levels. The International Monetary Fund makes use of the concept of fundamental disequilibrium, though fails to define it. Fundamental may refer to the size of the disturbance, and to its persistence. However, it has been difficult to single out any one kind of disequilibrium as more fundamental than any other.

Kinds of Disequilibria (DISEQUILIBRIA)

A committee of the O.E.C.D. found it useful in 1966 to make, "a broad distinction between cases where an imbalance is due to an inappropriate level of internal demand in the country concerned, to excessive or deficient competitive strength in world markets, or to excessive capital movements." It is admitted that multiple causes of disequilibrium can occur. In some cases the origin of payments imbalance is comparatively straightforward, as is its cure. An inappropriate level of demand should be corrected by a change in internal demand; excessive or deficient competitive strength by exchange rate adjustment, and excessive capital movements by control of capital movements.

This is too simple. It fails to penetrate to the causes of the inappropriate level of demand or the change in competitive strength. It makes no allowance for a deficiency of long-term capital movements, leaving the implication that these movements can be too large, but not too small.

Let us distinguish between equilibria with and without long-term capital movements or with insufficient capital movements. In the absence of long-term capital, or with insufficient movements, disequilibria can be classified broadly into those stemming from income, those from

structural causes, involving relative prices, and those which are a mixture of income and price. The following table presents a classification scheme of this sort, divided as well into short-term and long-term influences.¹

Kinds of International Disequilibrium

	Income	Income and/or Price	Price
Short-term	Cyclical Disequilibrium	Inflation ; inappropriate exchange rate change	Structural disequilibrium at the goods level.
Long-term or deep seated	Secular Disequilibrium	Systematic technological change	Structural disequilibrium at the factor level.

Income disequilibria are those in which income changes in relation to national incomes abroad (or vice versa) without significant changes in relative prices ; structural changes are those which occur primarily in relative prices, without necessarily significant changes in the level of national income. The intermediate category includes the case of over and undervaluation of the exchange rate produced by changes in the exchange rate, or by domestic inflation. These are cases of income and price. It also covers systematic technological changes which may produce increases in money income, reduction in prices, or both. This breakdown may appear to be highly arbitrary because in the real world changes in incomes are bound to affect relative prices. Similarly, changes in relative prices do affect total level of income.

Inflation

Several economists relate the difficulties in the balance of payments to domestic inflation. Therefore such imbalances would be rounded by following the policy of deflation (eliminating the inflationary gap and reducing effective demand to the level of full employment), or at least by halting the inflation and adjusting the exchange rate.

Improvements in the balance of payment position came about in the following manner : (i) Decline in incomes reduces imports directly and releases goods previously bought in the home market for sale abroad. (ii) Reduction in prices attracts foreigners to buy and dissuades them from selling, thereby stimulating exports and reducing imports. (iii) In these days of administered prices, deflation results in the cancellation of domestic orders and thus reduces delays in filling orders for export. (iv) The halting of inflation and the correction of exchange rate tend to reverse destabilising speculation and lead to a return flow of domestic capital and a reconstitution of foreign working balances.

Where inflation is demanded, through excessive consumption investment, a governmental expenditure, the disequilibrium is primarily of the

1. Charles, P. Kindleberger : International Economics (Homewood, Richard D. Irwin 1968, p. 478).

income variety, although as just mentioned, these will be price distortion. Where inflation is the result of a wage-price push—administered wage increases being followed by rises in administered prices—one can point primarily to price relationship. If the country sells in highly competitive markets, export prices are given and the inflationary pressure will squeeze profits out of exported. Where the exporters themselves administer their prices, profit-margins may remain intact, but goods will gradually be priced out of world markets.

We refer to relative and not to absolute inflation. If all countries inflate at the same rate and no money illusion exists, no balance of payments problems emerge. But they emerge because the tendency to overspend, or the wage-price push, is faster in one country than another.

Cyclical disequilibrium occurs either because the patterns of business cycles in different countries follow different paths or because income elasticity of demand for imports in different countries are different.

Under secular stagnation, investment opportunities are inadequate to absorb full employment savings; in periods of secular exhilaration, on the contrary, investment is too high relative to the savings of the economy. The cause of imbalance in the Keynesian system is that the forces lying behind savings and investments are different, and both are relatively inelastic with respect to the rate of interest. In the early stages of growth when investment opportunities exceed savings, a country may make up the gap by international borrowings. At a later stage as its income and savings rise beyond its investment requirements, it pays back debt and accumulates foreign investments of its own. Still later, its propensity to save may shift downward as consumption rises through demonstration effect but the productive drive flags. At this stage the country may choose to consume some of its accumulated foreign capital. When long term capital movements are different, disequilibrium results. If young and vigorously growing countries have investment opportunities in excess of domestic savings, and land and labour, but foreign loans are not available, they are likely to run deficits on basic balance. On the other hand, a rich country having abundant savings relative to its investment opportunities, but lacking the institutions to invest abroad, will show a persistent surplus on basic balance. In a world of countries at different stages of growth and growing at different paces, long-term capital movements are needed to offset excesses of savings over investment in some countries, and deficiencies in other. When such long-term capital movements are limited, as happened in 1930, the result is secular disequilibrium.

Technological Changes

Technological changes in the shape of innovations rather systematic innovation have an independent influence on the balance of payments. An innovation in country leads to increased exports or to reduced imports from country B, with a transitional deficit for B until the position settles down with a new comparative advantage. However, if A continues to innovate in different fields, and B continues to face deficit, B faces the problem

of secular disequilibrium. Several economists Williams, Crowther, Robertson, etc. attributed the U.S. surplus and world deficits in 1957 to U.S. systematic innovation. When the U.S. faced deficits in 1951 or in 1958, the cause according to Samuelson was the Europe's closing of the U.S. technological gap. However, nothing definite can be stated here.

Structural disequilibrium at the goods level

Structural disequilibrium at the goods level occurs when a change in demand or supply of exports or imports alters a previously existing equilibrium or when a change occurs in the basic circumstances under which income is earned or spent abroad, in both cases without the requisite parallel changes elsewhere in the economy. Let us take the case of change in demand, suppose there is decline of world demand for Malaysian Rubber due to the growth of import substitutes. The resources previously engaged in rubber production must shift into other lines of activity or adjust their expenditures downwards. Taking the country as a whole, the displaced resources must shift into some other export line or the country must restrict imports. If the required changes do not occur, the country will experience a structural disequilibrium. Similarly, a crop failure may restrict a country's exports and produce a shortfall of exports below imports leading to structural disequilibrium. Again the loss of service income resulting from confiscation of investments abroad may lead to structural disequilibrium.

Structural Disequilibrium at the factor level.

Structural disequilibrium at the factor level results from factor prices which fail to reflect accurately factor endowments. If the price of labour is too high, the country may use labour sparingly and may import goods with a high labour content than is appropriate. The country's comparative advantage, in other lines will be overstated. Either the country will face a disequilibrium in the balance of payment or will find unemployed resources to dispose off.

In a broader sense, the balance of payments is in disequilibrium when factor prices, out of line with factor endowments, distort the the structure of production from the allocation of resources which appropriate factor prices would have indicated. In the narrow sense, tariffs, subsidies, etc., result in below optimum efficient equilibrium.

EXCESSIVE CAPITAL MOVEMENTS :

While for a long time, persistent disequilibrium was the consequence of hesitant capital movements, the problem of excessive capital movements is posed in the 1960's, capital flight is one form of excessive capital movement. A less developed country with high propensities to invest and limited saving needs capital imports but may suffer from capital exports, as its wealthy citizens move their funds abroad to escape taxation, confiscation or the threat of war. Similarly, the crisis of confidence may provoke certain countries to withdraw their accumulated reserves from one centre and transfer them to a different financial centre.

".....A question remains whether international financial intermediation should be regarded as involving excessive long-term capital flows, or as pointing up the limitations of the major concepts of international equilibrium."

MEASURES TO CORRECT EQUILIBRIUM

(a) **Financing.** Measures to correct equilibrium presuppose an analysis of the causes of the disturbance. If the monetary authorities feel unsure, they may try to finance the exchange pressure out of reserves. Reserves may be permitted to fall in the hope that the exchange pressure will prove transitory or its causes will be known clearly. If their reserves are insufficient or if the authorities do not like to run them down, the authorities are likely to increase their short-term interest rates, through the lever of Bank rate. This increase in the Bank rate by the Central Bank is likely to influence the short-term interest rates as a whole in the upward direction. There is usually a large pool of international liquid funds willing to move from centre to centre to secure a more attractive rate—always provided that this does not involve undue exchange risk.

An increase in Bank rate will normally succeed in tapping part of this international money pool. In this way the latent deficit on the exchange market may be covered by private financing. However, the private financing may not be sufficient and the authorities may not be willing to raise the Bank rate in the interests of domestic economy. In such a case the authorities try to bolster their reserves by official borrowing.

This type of financing, whether private or official, is appropriate only if the deficit is likely to be temporary and is likely to be reversed. For example, short-term funds may leave a country for political fears which are temporary. Again the domestic economy may be booming while the international economy is weak. This is likely to be reversed. In such situation the financing as discussed above is justified.

A decline in business activity abroad exerts a curb on exports, as foreign markets weaken. There is no corresponding fall in imports, rather imports may increase as foreigners may try to sell more exports. This is the kind of external deficit for which domestic deflation is most inappropriate internationally, as it may quickly propagate the localized recession into an international slump. This dangerous prospect of a slump in one country forced the inclusion of two clauses in the international Monetary Funds: "Scarce currency clause", authorizing collective discrimination against a surplus country and 'devaluation' in case of fundamental disequilibrium.

Financing is the most appropriate cure for deficits of this kind, but the pool of liquidity needed would be large. Again financing is justified so long the situation is likely to reverse itself. For example, a country with a large agricultural sector suffers a bad harvest. If the prospects for

the next year are good, this year's extra imports could be financed from the reserves, but if it looks that this may suffer from a run of bad crops, more positive action will be needed.

(b) **Deflation.** A monetary inflation, of prices and incomes, pushes domestic prices to a point at which exports are uncompetitive and imports unduly cheap by comparison with inflated prices of home produce : and causes an excess of monetary demand that, in addition to its pressure on prices, sucks domestic goods away from export markets and sucks in more foreign goods as imports. The obvious remedy is a straight forward deflation of spending. Disinflation (i.e., deflation to the point of full employment but not beyond) is appropriate to reduce pressure both on domestic prices and on the payments balance. However, if inflation has persisted for long and has resulted in permanent increase of costs, then disinflation alone may not be sufficient. The way out may be toward real deflation (i.e. taking the economy below the point of reasonable full employment and sustained growth) and keeping it there until it shows the necessary response in lower wage costs, as well as in lower absorption of imports at the lower level of domestic activity.

(c) **Devaluation.** If the government is reluctant to rely on deflation alone, which removes the excessive external spending by cutting down the amount of total spending power even more, then it may additionally attempt to shift the proportion of domestic income and output that goes into the trade balance, through reducing the external value of its money. This will be proper for deficits caused by 'structural change'. These structural changes may be—the loss of overseas investment income or adverse turn in the terms of trade, a relative fall in the world's demand for country's main export products, an adverse movement in productivity, etc.

These are all shifts in real conditions as distinct from temporary monetary disturbances and they require real changes in the disposition of domestic resources. If these shifts are induced through monetary form, devaluation will be the normal instrument.

If the economy is operating well below the level of full employment, devaluation alone may be sufficient. However, if the economies are operating at a near or above the full employment level, devaluation may have to be accompanied by measures of domestic disinflation. This will be necessary to offset the expected improvement in the trade balance itself, which whether through increased exports or reduced imports removes goods from the domestic economy without reducing purchasing power. This is the other aspect of the operation of increasing the proportion of domestic output that is exported—which adds to this proportion of output that is paid for without putting goods as the home market ; and of decreasing the portion of national income that is spent as imports—which takes goods of the home market without reducing purchasing power.

A country with large excess and with too large payments deficit, requires deflation much more than devaluation. Without devaluation,

deflation required may be less and might be working on lesser additional demand, because of extra exports and fewer imports. Deflation will alone involve a smaller net deflationary imposition if the focus is on the balance of domestic economy. If the focus is on eliminating the payments deficit then deflation may have to be large involving a multiple reduction of total spending to achieving the needed effect in the trade balance. However the addition of devaluation by its effect on the direction of spending and resource allocation, should allow payments balance to be restored without dragging the domestic economy in its wake. All this assumes that deflating to the point of full employment and the domestically sustainable pace of expansion is not itself sufficient to restore payments balance.

Controls. These fall on imports through quotas, tariff surcharges or exchange controls. They, like devaluation, work by shifting the disposition of domestic resources and purchases within the economy. They will also need some accompanying reduction of domestic spending or tightening of domestic credit if it is considered necessary to neutralize their domestically expansionary effects.

The choice between the use of exchange rates and controls is mainly an ideological and administrative one. Variations of exchange rates were preferred by the proponents of free enterprise system. Controls were preferred by those who were suspicious of the efficacy of market mechanism.

Prof. Fritz Machlup feels that only devaluation and deflation are real adjustment mechanisms, because they both act on incomes and prices. Two reasons are forwarded : (i) Controls like import quotas, ban on foreign lending etc. merely dam up the excess spending power that had been spilling overseas. They neither eliminate this excess spending, qua deflation, nor absorb it through the higher foreign trade prices brought by devaluation. (ii) Such administrative actions are entirely arbitrary and their effects cannot be predicted. This criticism signifies that direct controls must be accompanied by appropriate internal measures, including an absorption of excess purchasing power through disinflation. This does not make controls ineffective because devaluation itself is accompanied by deflation. The reason is devaluation automatically results in some independent increase in domestic prices and brings automatic restraint on real income. Besides this, devaluation avoids a misuse of resources. Controls have become import biased. There is the further difficulty of inviting retaliation from other countries. Hence devaluation is preferred to controls in correcting a deficit in the balance of payments.

MEETING EXTERNAL DISEQUILIBRIUM IN UNDERDEVELOPED COUNTRIES

Q. "A poor country either must finance investment out of domestic savings or borrow long-term capital from foreign countries." Discuss.

Or

How would a developing country meet its external disequilibrium ?

Ans. G.M. Meir in his book "International Trade and Development"

makes an illuminating attempt to discuss the disequilibrium problems of a poor country and suggests ways to solve them¹. According to him a poor country can avoid external unbalance if the investment is financed by non-inflationary means. When, however, national expenditure increases by inflationary methods—through private or public deficit spending or through dissavings—the expenditure will exceed the increase in output, and an external imbalance will result. The imbalance between imports and exports is simply the reflection of an imbalance between domestic investment and savings or between government expenditure and taxation.

Assuming that imbalance is caused by inflationary pressures and further it cannot borrow from abroad, the only way for her is to reduce her national expenditure to the level of her national output. In this inflationary situation neither import restrictions nor devaluation alone will prove effective in removing the external imbalance; these measures must be supplemented by policies that will also lower the rate of absorption. Import regulations and devaluation can succeed if the demand for exports was inelastic, so that export revenue increased as export prices rose, and this increase in export revenue were saved. However, generally, the inflationary pressures will weaken the competitive position of exports, increase imports and provide a deterrence to the inflow of foreign capital, and encourage to the capital flight. Moreover, import controls can only suppress the disequilibrium if they are retained on a long-run basis.

However, restrictions on imports on a long-run basis are likely to lead to bottle-necks in production as stocks of imported materials are worked down to low levels. Monopoly elements may be strengthened and unusual profits may be made by private entrepreneurs. Costs will be increased and competitive position of export industries will be weakened. Besides, resources will be diverted to import-competing industries at the expense of export development. Thus when import controls are added to an inflationary economy, the allocation of resources becomes even more distorted and low productivity results.

The other possibility—the adjustment of exchange rate—is also likely to fail. Even if the elasticity of demand for imports and elasticity of supply for exports are sufficiently high to rule out the perverse case of devaluation, devaluation should be accompanied by a fall in aggregate real expenditure so as to allow an improvement in the trade balance through an increase in export volume and a fall in the import volume. However, devaluation involves inflationary pressures which cancel the devaluation unless deflationary measures are followed. Consequently, monetary expansion should not be allowed to offset the equilibrating effects of devaluation.

However, if the money supply is kept constant, real absorption may be automatically reduced by the rise in price level and the reduction in

1. Gerald M. Meir, *International Trade and Development* (Newyork, Harper and Row, 1963, p. 76).

the real value of total cash balances as a result of devaluation. Besides the effects on absorption of the rise in the level of prices, the relative price changes associated with a change in the terms of trade will also affect absorption, through both the income effects and substitution effects of the change in the terms of trade. In general, relative price changes and income expenditure adjustments combine to determine the effects of devaluation.

Internal balance may be maintained if a policy of import control or devaluation is supplemented by adequate monetary and fiscal policies of "disabsorption". But if the required "disabsorption" of resources is sought through a restriction of investment and government expenditure, this will reduce consumption. Since additional savings may not be mobilized out of current consumption, these may be mobilized out of current increases in output through taxation. If the import content of investment is higher than the import content of marginal consumption expenditures, the balance of payments situation will not be eased immediately, but it will be eased eventually as the investment results in additional domestic production and as resources are released from the domestic consumption sector for the export and import competing sectors.¹

If investment cannot be financed out of domestic savings, long-term capital from foreign countries must be borrowed. This will reduce the need for internal and external controls or continual depreciation. This does not imply that adjustments within the balance of payments are ruled out and that foreign borrowing presents no problem. This only emphasises the need for domestic savings, (and in its absence (of foreign borrowings) if external disequilibrium is to be corrected without sacrificing development.

Suggested Readings

- | | |
|----------------------------------|---|
| 1. C. P. Kindleberger | : International Economics |
| 2. Fred Hirsch | : Money International |
| 3. American Economic Association | ; Readings in the Theory of International Trade |
| 4. R. Triffin | : Europe and the Money Muddle. |

1. Gerald M. Meir, *International Trade and Development*, p. 82.

MECHANICS OF THE FOREIGN EXCHANGE

Q. Describe the functions served by the foreign exchange market.

Or

What purpose is served by forward exchange market ? *Or*

Why do countries wish to avoid the world financing role for their countries ?

Ans. Different countries use different money. Monetary transactions between them require special processing. This forms the basis of world's foreign exchange markets. Foreign exchange is traded against the domestic money in every commercial city. Hence each such conversion throughout the world forms a part of world foreign exchange market. The price of national currencies in terms of foreign exchange is important and invite governmental intervention.

The foreign exchange market has throughout history served three functions :

1. It acts as an auction ring and clearing house, setting the terms on which the different national monies exchange for each other, and arranging the mechanics of the settlements.

2. Operators take views of the future relative values of the different currencies while trade, and provide a facility whereby the public can take such views and express them in monetary form. This is the speculative function of the market. An exchange rate is a price ; it is not just another price. In foreign exchange market's price variation is the natural state and any desired degree of stability has to be imposed.

3. Dealings in foreign exchange have often been linked with the extension of credit internationally. From the medieval bill of exchange and the modern European-dollar deposit, credit is tied in with a number of the instruments used in the foreign exchange market.

The Market :

Every country's domestic currency makes up part of the world foreign exchange market, in the sense that it is possible in some form and buy that currency and other currencies. However, sometimes governments have

any such private dealings. Moreover, frequent fluctuation in values of a particular currency against other countries renders that currency inconvenient. Thus authorities have to assure convertibility. However, only 31 of the 107 members of the International Monetary Fund assure guarantee convertibility into other foreign currencies at a rate within 1 percent of their official exchange parity.

The international financing function has three aspects :

1. The currency can be used for new foreign financing ; i.e. new net lending.
2. Once this lending has put the currency into international hands, this will itself normally create a pool of foreign-owned balances in the currency. In this second phase, new lending will be possible from the proceeds of accounting repayments, either by the initial lenders, or by intermediaries who dispose of part of this pool of foreign held balances. This will involve a faster turnover of existing foreign balances rather than an increase in their total size through new lending by the country whose currency it is.
3. The currency may be used in the foreign exchange market simply as an exchange medium.

In the nineteenth century London developed as the outstanding centre for the finance of international trade. This happened because London itself dominated world trade and there developed a range of specialist institutions granting credit facilities on different terms. From this grew up the habit in the commercial world of invoicing trade in sterling, even when the trade was between third countries and did not touch Britain itself.

Since 1914, London has been forced to restrict the new foreign lending function. Dollar has come to share this function of London. Usually the countries avoid this world financing role for several reasons :

1. A financial centre needs a range of financial institutions that can offer the necessary services for trade financing. These include banking, insurance, shipping, brokerage, confirming house, etc.
2. It needs a country that is not only readily available to foreign holders ; it should also not be regarded as too desirable in its prospects of possible appreciation against other countries—for if it is, the holders will hold it and not use it. This happened to the dollar in 1947 and to mark in 1957. A country reaches its zenith in international financing just when it can afford it least. The use of the mark for foreign lending increased substantially in 1965, just when Germany's own payments swung into deficit. Moreover, the currency concerned is used as a reserve and is held officially by foreign governments and central banks. This reserve currency function complicates the internationally trading function and poses a serious problem for the countries-concerned.

Foreign Exchange Business

This exists on a number of different planes :

1. **Trade.** First there is the ordinary commercial business stemming from international trade. An American purchaser of Scotch whisky puts in an order for sterling against dollars to pay for it.

2. **Physical Investment.** On the next plane there is business coming to bank from customers to finance special large investment transactions—an American oil company needs the equivalent of \$ 30 million in Dutch guilders to put up a new refinery.

3. **Financial Investment.** Then there is the business coming to banks to finance purely financial transactions. The same oil company may see the opportunity of earning a better interest rate on its liquid assets by investing them at short-term in London rather than in Newyork. This transaction will probably involve a double exchange deal, or 'Swap'.

4. **Professional dealings.** These consist of dealings undertaken by banks in the foreign exchange market on their own behalf or on behalf of professional speculators.

THE FORWARD EXCHANGE MARKET

The forward market for exchange is a segment of the foreign exchange market. The transaction of this market are known as forward exchange as distinguished from spot exchange. The spot rate refers to the rate prevailing at a particular time, the foreign exchange required being made available on the spot. The forward exchange rate is the rate at which a future contract for foreign currency—to buy or to sell—is made on the basis of the spot rates ; the settlement is to be made at the end of the specified period.

Demand and supply determine the forward exchange rates. If demand exceeds the supply of a foreign currency, its price goes up and the foreign currency is quoted at a premium. On the other hand, when supply exceeds demand for foreign exchange in the foreign exchange market, the foreign currency is quoted at a discount.

Assuming no anticipated movements of foreign exchange rate, the future rate will be the same as the spot rate, if rates of interest are the same in the two money markets. In case the rates of interest differ in the two markets, forward exchange rates will reflect the difference. If the forward exchange rates do not reflect the difference between the interest rates, interest arbitrage operations would emerge. Arbitrage operations refer to buying and selling foreign currency against local currency with the idea of getting profits as a result of differences in the rate of exchange in the two markets. These operations would lead to the equality of the rate of exchange in both markets.

The forward exchange market provides facilities for hedging antici-

pated or actual claims or liabilities. Thus the exchange risks of the particular firm are reduced. It permits banks to cover their commitments who do not carry considerable foreign exchange reserves.

THE GOLD STANDARD

“And these metals [gold and silver], which other nations do as grievously and sorrowfully forego, as in a manner of their own lives, if they should altogether at once be taken from the Utopians, no man there would think he had lost the worth of one farthing.”

—Thomas More, *Utopia*, 1516.

Q. What is understood by gold standard? What are its legal pre-requisites?

Describe the adjustment process under the gold standard system? Does it demand any pre-conditions? Suggest them.

Ans. The gold standard was the dominant international monetary system in the last third of the nineteenth century and the first third of the twentieth. Upto the First World War it operated in such a way as to achieve a tolerable degree of internal and external balance in the world; after its restoration in the twenties it worked much less satisfactorily.

The legal requisites for a gold standard are: The Central banks or treasuries of the major trading countries must be willing to buy and sell unlimited amounts of gold at fixed prices, which must be practically the same for purchases and sales; moreover free import and export of gold bullion or coins must be permitted. As a consequence exchange rates are almost precisely fixed by the authorities.

THE GOLD-STANDARD ADJUSTMENT PROCESS

Here we shall consider the adjustment process following a shift in taste which reduces the demand for the home country's goods, and increases the demand for the goods of other country. Two forces set the gold standard adjustment process. These are banking reactions and the multiplier induced reactions.

Outflow of gold arises from a balance of payment's deficit. It leads to automatic contraction in the monetary circulation and to rising interest rates and restrictive bank lending policies. The country receiving the gold inflows exhibits the opposite tendencies. Central Banks of the countries concerned are following favourable policies. They raise the Bank rate when gold is lost and lower it when gold is being gained.

Higher interest rates attract short-term capital in the gold losing country and thereby reverse the tendency to lose gold. Further higher interest rates and reduced bank credit lead to a reduction in stocks held by traders which in turn lead to a fall in demand for imports. In the country with lower interest rates opposite tendencies occur. Rising interest rates also tend to cause a reduction in the level of activity in the

country losing gold. This effect becomes stronger so long the gold outflows continue.

Level of activity is also affected by the multiplier process. The change in the balance of payments itself has a direct effect on the level of activity in each country. The country losing gold finds adverse balance of trade and declining incomes of its residents. Here the contractionary multiplier process occurs. In the other country with gold inflows the expansionary process occurs.

In general and in the long-run the banking forces and the multiplier forces operate together. Both together lead to a change in the level of activity. Thus there must be unemployment in the deficit country and a reduction of unemployment in the other country.

Changes in the level of activity lead to an alteration in imports. In the country where the level of activity declines, imports fall while they rise in the other country. This leads to reduction in the gold flow from the deficit country. Thus the consequent improvement in the balance of payment depends on the size of changes in the level of activity. The multiplier changes, by themselves, do not restore equilibrium in the balance of payments except in the limiting case where the marginal propensity to save in each country is zero. On the other hand, declines induced through banking reactions continue for as long as the gold flows continue. They lead to an improvement in the balance of payments of the deficit country which continues until such time external balance is restored.

This movement towards restoration of external balance cause a serious disturbance in internal balance in both countries. The internal balance is restored through changes of relative price levels in the two countries. In the ideal adjustment process, wages and prices tend to fall in the country with the low level of activity and rise in the other. This leads to change in demand from dearer goods to cheaper goods in both countries. If the demand elasticities are high enough, total expenditure on the goods of the country with the lower level of activity rises, the reverse happens in the other country. Thus the relative price changes lead to some improvement in the level of activity and some improvement in the balance of payments in one country. There would be some deterioration in the other country in both cases. Precise proportions of both would depend upon several assumptions.

Changing price level leads to changes in the transactions demand for money which in turn will influence the interest rates. Thus precise situation at any time depends upon the play of several forces through time. However, if the situation reaches equilibrium, it will be at the position of internal and external balance. Only at external balance no gold flows occur and consequently no forces acting on the internal situation emerge. In the case of internal balance prices tend to be constant and so do not disturb the external situation. The only possible equilibrium, therefore is one where both internal and external balances are restored in

both countries, while either kind of balance is absent, forces are at work to move conditions away from the existing situation.

CONDITIONS FOR FULL ADJUSTMENT

The following conditions must be satisfied if the equilibrium is to be attained and is to be attained smoothly and quickly :—

- (i) Change in the level of activity is an essential stage in the adjustment process.
- (ii) Adjustment to equilibrium, if it is possible at all, will eventually take place.
- (iii) Adjustment will take place eventually even if there are no changes in the monetary situation in either country.
- (iv) Adjustment will not take place if price changes lead to exaggerated expectations of further price changes.
- (v) The process of adjustment may fail to reach equilibrium if marginal propensities to import in the two countries are very large. In such a situation demand for other country's goods is contracted ; interest rates are rising, level of activity rises in the home country which means that prices rise in the home country losing gold. Equilibrium is impossible.
- (vi) Adjustment may not be possible if the sum of the price elasticities of demand may be too small. In such a situation more money may be spent upon dearer goods and less upon cheaper goods. This leads to a deflationary situation in the country where prices have fallen. The balance of payments position deteriorates still further. Thus the movement is away from equilibrium position.

Q. What criticisms have been directed against International Gold Standard ?

Ans. Criticisms against the International Gold Standard. The following criticisms against the International Gold Standard are made :

(a) Exchange rate stability becomes the dominant goal and domestic monetary and fiscal policies have to be pursued to maintain this stability. This calls for quick and appropriate flexibility in interest and wage rates, commodities' price level, relative prices and in book values of assets and liabilities. The money and quasi money stock has also to be flexible. The International Gold Standard makes the Central Bank and monetary authorities all powerful and consequently leads to the subordination of fiscal policies to monetary policies.

(b) The pursuit of external value stability signifies the acceptance and the readiness to face unemployment and overful employment possibilities.

(c) Domestic price levels in different countries under the International Gold Standard would be seriously affected. The autonomous gold supply accruing to the Central Bankers and variations in private hoarding and in gold outputs would affect the price levels. Consequently either world wide inflation or deflation may occur depending upon the relation between growth of gold supplies and world production.

(d) Domestic authorities would be powerless and surrender the power to International Gold Standard to introduce measures of forced savings through monetary means.

(e) Huge resources are wasted in gold mining and in gold stocking.

(f) The International Gold Standard poses a challenge before the co-operative spirit of nations to evolve a better and positively more economic arrangement for international trade. Speedier steps should be taken to the realization of a managed international currency.

Among the criticisms, the first two are serious and sharpen the conflict between the International Gold Standard and domestic policies. Domestic fiscal and monetary policies may have to be reversed under the dictates of balance of payments position. In general, the prospects of deflationist bias are greater in domestic policies as supplies of gold are relatively inelastic. Under the International Gold Standard each country has to keep in step with the other. The consequences of falling out are rather dangerous. Countries, with small involvement in trade or of small size are faced with such dangers.

Q. Can you identify the countries representative of Keynesian and classical approach? Briefly describe their differences.

Ans. We can work out a two sector or a two area model of the world monetary system since the fifties. The United States and the United Kingdoms fall under the Keynesian group of countries. (The United Kingdom will have to change its policies since she has decided to join the European Common Market). The Western European Countries may be termed as belonging to the classical group of countries. Keynes criticised the International Gold Standard, because it made the domestic goal of achieving full-employment subservient to the goal of exchange rate of stability. Domestic monetary and fiscal policies were unduly influenced by external events. The required interest rate adjustment to suit the requirement of domestic exchange stability may upset the flow of investment. Besides a gradual rise in prices becomes associated with the growth towards full employment objectives. The balance of payments goal must be subservient to attain the domestic goal of full employment. The deficit in the balance of payments are corrected by B.I.S. loans, currency swaps, Roosa Bonds and Fund Loans. If these arrangements do not succeed, the resort is made to exchange control. The Keynesian group of countries would prefer to reform the International Monetary Fund in such a manner so that automatic expansion in the claims of these countries emerges. Such expansion enables these countries to finance the deficit to

the balance of payments without much monetary and fiscal discipline at home.

The classical group of countries favours a gold-based international monetary system. Exchange rate stability becomes the dominant goal. Necessary modifications in domestic monetary and fiscal policies are made. Much emphasis is placed upon savings and productivity as the foundations of growth. With comfortable reserves, they would not hesitate to spend since most of the countries belonging to this group are small, they cannot introduce any major political goals in their economic decisions. They are guided more by economic criteria.

The differences between the Keynesian and classical group of countries, at the deeper level would be following. While the Keynesian group of countries are afraid of unemployment and depressing tendencies because of the fear of deflation ; the classical group of countries are afraid of inflation and expansion because of inflation. They would like the international system to have a solid basis in real purchasing power, but the Keynesian group would like to dispense with gold if possible.

THE PURCHASING POWER PARITY THEORY

Q. Explain the purchasing power parity theory. Is it better guide to the fixation of rate of exchange than the gold standard ?

Examine critically the purchasing power parity theory of foreign exchange. How does it differ from the classical theory of foreign exchange ?

Discuss the limitations of the purchasing power parity doctrine.

Ans. This theory claims that the foreign-exchange rate is determined by the ratio between the real purchasing power of the two currencies ; the price levels in the two countries would thus be the independent variables, the exchange rates the dependent variables of the relationship. In simpler words, the purchasing power of one currency will be equal to that of another currency at the rate of exchange which will reflect the equality or parity of the purchasing powers of the two currencies. The purchasing power of a country depends upon the price level of the country. If the price level rises, the purchasing power falls. If the price level falls, the purchasing power increases. If the purchasing power of a country falls, its rate of exchange would fall. If it increases, its rate of exchange rises. In this way the rate of exchange moves in the same direction with the purchasing power which moves inversely with the price levels in the countries concerned. In this way, the movements in the price levels brought about changes in the external purchasing power of currencies or the rate of exchange.

How originated :

During the First World War trade had been interrupted, monetary conditions had followed different ways and the problem was to choose a new exchange rate which would balance the accounts. The Swedish economist, Gustav Cassel, suggested the purchasing power parity as the appropriate level at which to set the exchange rate. This was calculated by

measuring relative departures of price levels from same base period when the balance of payments had been in satisfactory adjustment. Two countries, A and B, whose payments were in reasonable adjustment in period 0, should choose an exchange rate (R) which reflected the changes in their prices between period 0 and a later period 1 :

$$R_1 : R_0 = \frac{P_{a1}}{P_{b1}} : \frac{P_{a0}}{P_{b0}}$$

$$R_1 : R_0 = \frac{P_{a1}}{P_{a0}} : \frac{P_{b1}}{P_{b0}}$$

If prices (P) in A doubled relative to prices in B, from period 0 to period 1, the exchange rate (R) should fall to half (or the price of foreign exchange expressed in local currency should double). This is the relative version of the purchasing power parity doctrine. Another and absolute doctrine rests on the assumption that goods prices should be equalized by trade everywhere in the world, where goods cost more in A than in B, when A's prices are converted into B's currency at the existing exchange rate, A's currency is overvalued by the percentage of the higher cost.

The absolute version of the purchasing power parity cannot, of course, depend on the equalization of goods prices by trade. Transport costs prevent such an equalisation of goods prices. Houthakkar however defended the absolute version in the following way. Trade brings about something approaching factor price equalisation. With factor price equalization and identical production functions for non-traded goods, non-traded good prices will be the same in countries joined by trade, despite the impossibility of joining such markets through goods movement.

The purchasing power parity doctrine assumes that the balance of payments was in equilibrium in the base period, and further that there have not been "structural" changes in the factors underlying this equilibrium, i.e., changes in technology, resources and tastes, including this propensity to save. Reduced propensity to save leading to a change in capital movement would distort the purchasing power parity. If the country has surplus savings and invests them abroad in period 0, but consumes at higher and save at a lower rate in period 1 so that capital exports decline, domestic prices can be higher in period 1 relative to period 0, since there is no need to transfer capital abroad. In an example furnished by Samuelson, with constant costs, and three commodities, where previously country A exported commodity X, and imported commodities Y and Z, a change in tastes now requires A to export X and Y and import Z. No change in costs or prices takes place, but the exchange rate must alter to shift good Y from imports to exports,

The choice of what price index to use in calculating purchasing power parities has been a tickling one. If one takes the prices of internationally traded goods for which transport costs are unimportant, the law of one

price makes the doctrine a tautology. Such goods are traded in a single market, and in a single market there can be but one price. Consumer price indices contain non-traded goods. They therefore get away from the tautological content of the doctrine.

But consumer price indices contain a lot of personal services which are not only traded, but the prices of which diverge with economic growth. The reason is a complex one. With improved efficiency, wages in efficient industries rise. Wages can rise and good prices remain unchanged in these industries because of technological improvement. But wages have to rise as well in the industries with little or no technological change, in order for them to retain their labour. With constant efficiency and rising wages, these prices have to rise. To the extent that personal services—in barber shops, the lawyer, the doctor's services, teaching etc.—rise in price, they affect the consumer price index without impinging on the balance of payments. In a world of one-sided technological progress, absolute and relative departures from purchasing power parity cannot be measured by the cost of living.

The point can be made more generally. There are differences in the purchasing power parity, and in the implicit exchange rate, for different type of goods. Exchange rate of the more productive countries tend to be increasingly overvalued as one moves from commodities to services. It is thoroughly misleading to compare real incomes per capita between countries by converting money incomes at going rates of exchange.

Finally, it should be added that the purchasing power parity doctrine applies best only to current account transactions, while exchange markets are influenced by many types of capital flows as well. Switzerland traditionally has a current account deficit, indicating that its prices of goods and services may be comparatively high. Yet Switzerland's currency is traditionally strong in the exchange market owing to the large inflows of liquid capital and, in times of crisis elsewhere, it is often a candidate for revaluation upwards. The purchasing power parity doctrine is designed for trader nations and gives little guidance for a country which is both a trader and a banker.

One may not agree with the assertion of the theory that changes in price level induce changes in the exchange rates. It may happen otherwise. That is changes in exchange rate may occur due to other reasons and they may lead to changes in the price levels in the two countries. In this way national price level, may follow rather than precede the movements of exchange rates.

In the real world government intervention causes exchange rate to deviate widely from purchasing power parity through high tariffs, import embargoes, import quotas the government tries to limit the number of rupees offered in the exchange market and to keep the value of the rupee higher in this market than it would be if imports were unrestricted. In this way deviations in the exchange rates from those based on purchasing power parity occur.

FLEXIBLE RATES Vs FIXED RATES

“No matter what problems a country may have, their manifestation as a balance of payments problem is always a consequence of government policy.”

—Harry G. Johnson

Q. Why do governments hold international monetary reserves? What determines the size of these reserves?

Discuss the merits and demerits of flexible rates and fixed rates as adjustment measures to correct the imbalance in the balance of payments.

Ans. Imbalances occur persistently and need for adjustment mechanism to correct these arises. The adjustment can be arrived at either of two measures: (1) exchange rate variations; and (2) monetary contractions in deficit and/or monetary expansion in surplus countries.

The monetary contractions or expansion are applicable under the gold standard rules with fixed rates. Here the immediate impact of a balance of payments deficit is a decline in reserves, and of a balance of payments surplus, a rise in reserves. It is the changes in the level of reserves that lead to domestic monetary and fiscal adjustments. In the fixed-rate system the adjustment is immediately imposed in order to replenish reserves or to dispose off the overplus in reserves.

The chief criticism against the fixed-rate system is that the announcement and shock effects of variations in reserves are less significant than the same effect in the wake of a variation in the exchange rate. (2) In a reserve based system, the accumulation of reserves becomes the dominant goal itself. These criticisms are not effective. Because variations in gold reserves do lead to change in domestic policies and may continue in the Flex system itself.

The advantages are: (1) The rate adjustment has to be big and will be undertaken after full discussion. Efforts will be made to reverse the drift of fiscal and monetary policies. The tendency will be to avoid such rate changes. (2) The Businessmen wish to avoid the change in accounting and consequent changes and the rigidity of institutional practises make them prefer the fixed rate system. (3) It is doubtful that the market will be able to gauge the strength of currencies. Its basis will be the movement of reserves. This will lead to the subservience of domestic policies to international markets. The chances of politics getting mixed up with economies are greater. Different countries with different economic strength and different public sector pose serious problems.

Most economists hold that the best solution to international monetary problems is the adoption of a system of flexible exchange rates. Given the conditions of competition implying perfect knowledge and perfect mobility, the relative exchange rates would be proportional to the real

purchasing power equivalents of different countries. Exchange rates should be free to vary according to changes in demand and cost conditions.

The flexible exchange system of a country may go on depreciating its exchange rate continuously because in other countries the employment goal may not be dominant. If other countries react in a similar way by depreciating their currencies, no advantages may accrue to the country concerned. The argument is conducted in micro terms. Any effort on the part of one to follow expansive monetary and fiscal policies for achieving full employment is immediately accompanied by the market indicator of sliding parity. This is brought about by speculators. With a solid parity, import goods will be expensive and export goods will become cheaper. As such immediate rectification of the deficit will follow. This, of course, presupposes ability and willingness to shift factors. Demand schedules are supposed to be elastic. If the cost-push effect of the rate changes can be ignored, a single country may enable itself through forced saving to recoup equilibrium in its balance of payments. If the cost-push effect is there and leads to a rise in prices, a further sliding of the rate will be necessary. At some stage the country might think in terms of drastic-structural adjustment.

The flexible exchange system permits the possibility of introducing structural adjustments earlier than under the fixed-rate system. Quick adjustments will be possible in response to changes in productivity rates if the dominant goal is not the pursuit of full employment.

The flexible exchange system gives great importance to the market mechanism. Each country should possess a well developed market for foreign exchange. Information should be available quickly and immediately dispatched, there must be near price flexibility within each country. No currency should enjoy special position. Exchange markets must be free and operators must be numerous. There must be perfect scope for demand adjustments to occur within each country. Rate adjustments should be reflected in levels of prices and costs.

Under the flexible exchange system given certain internal and international conditions, the need for any internationally acceptable liquid assets may be greatly minimized. Each country would be willing to settle the claims of other countries at the prevailing parities by exchanging her own currency for those of others. Any single country may resort to inflation as a source of supply of exchange, but such possibility is greatly limited. Inflation, would affect exports adversely; would reduce capital inflows and encourage outflows; even labour may move out. Demand for increased wages, salaries and servicing payment would receive strength. Continuous inflation would invite speculation against that country's currency. The upshot of all this is that country must settle its exchange claims through budgetary surpluses or voluntary savings in the domestic sphere.

"Given the best possible domestic and external environment, the flexible exchange system works under the two rules given on next page.

(1) If an economy has a balance of payments deficit, it must (a) earn budgetary surplus through step-up in taxation, (b) step up voluntary borrowings from the public through higher interest rates which incidentally will raise savings in the system, (c) attract short-term and long-term capital because of the upward drift in interest rates, and discourage outflow of capital, (d) undertake borrowings in international markets which involve suitable escalation-guarantees to the lenders and implies willingness to make those domestic adjustments needed to earn a surplus in the balance of payments.

(2) If the economy has a balance of payments surplus, it must (a) incur a budgetary deficit through tax-relief and/or step-up in fiscal expenditures, (b) reduce voluntary borrowings from the public, thus allowing interest rates to drift down and cause the savings ratio to be brought down, (c) discourage inflow of short-term and long-term capital, and because of interest differentials, encourage outflows of capital; (d) reduce borrowings from international markets and clear liabilities, particularly now that the exchange rate is in its favour. As one country's deficit must imply a deficit in another country or countries and vice-versa, the equilibrating adjustments will be strengthened by the opposite policies pursued in another country or countries.

It is suggested that flexible exchange systems lead to production shifts which lead to the establishment of equilibrium. Assuming a classification of all goods and services in the domestic economy on the basis of the component of imports in their production, a fall in the parity implies that the relative prices of the goods and services with an import-component higher than average in the economy would go up and the relative prices of the goods and services with an import component lower than the average in the economy would go down. Secondly, production methods in whose co-efficients the import component is higher than the average will become relatively costlier in relation to those methods in whose co-efficients the import component is lower than the average. Thus, on both the counts, the substitution effect will work against the high import-component goods when the parity is reduced. In the same manner, the use of domestic resources in exports would be encouraged as against their use for domestic consumption."

"The basic postulate underlying the neo-classical view on flexible rates is that consumption-mixes and production methods exist in nature (or in existing technology) in such an order that, when the exchange rates go down or up, the goods whose consumption is reduced or raised and the methods of production which are under use, or are discarded, are such that the direct and indirect import components in the goods and methods are lower or higher. Again the same result must hold with greater force as the extent of exchange rate change is larger.

The existence of order in nature or in technology, or consumption preferences cannot be justified in pure theory. For some reduction, import intensity of the economy may be, for some further reduction, the

intensity may be lowered ; for a still further reduction, the intensity may again be raised. A devaluation may even arise in import intensity and an appreciation may even imply a fall in import intensity. Results may be different for large changes in rates than for small changes.

The special status for flexible rates (once over or continuous) derives from the postulate of a downward sloping demand schedule for production inputs. Even if we assume variable co-efficients, a downward sloping demand schedule does not necessarily follow.

INTERNATIONAL RESERVES

The amount and kind of international monetary reserves that countries hold and want to hold have varied greatly in different periods, and have also varied very considerably within each period among different countries. The size of international reserves depends upon the following motivations :

1. Its desire for a cushion against future deficits, which are likely to be the larger the more it tries to govern its economic and monetary policy in accordance with particular domestic aims even when these pull against international influences.

2. The likely 'conversion' claims on its ultimate reserves, either from its own citizens or from overseas holders of its monetary claims. The ultimate reserves consist of gold and foreign exchange.

3. The possibility of supplementary reserves at times of payment pressures by access to credit in sufficient volume ; either through ordinary commercial markets or through official borrowing from other governments, central banks or other institutions.

4. Its readiness to impose direct controls to feed off payment pressures.

Countries do want larger cushions ; they disavow protective restrictions and controls ; they aim at maximum stability of exchange rates. Historically gold has served as the ultimate internal banking reserve against paper currency which has been convertible into gold. Externally gold has ceased to serve as a medium in settling private transactions between nations. It has been used more sparingly for settling net balances between countries. Gold is no longer freely circulated. It was no longer convertible into pound notes. Its free movements were deliberately checked across the countries. The price of gold was set by central authorities and especially the U.S. treasury which since 1934 had stabilized the gold price at £35 an ounce. This gold dollar link was used as a secondary link between other currencies and gold in the IMF system set up after the Second World War.

Gold has formed a decreasing portion of international reserves. It forms a still lower portion of international settlements. But gold served as this ultimate reserve and into which other forms of international money such as claims on sterling, in dollars or on the International Monetary

Fund are ultimately convertible. This carries its own dangers. It involves the building up of a fractional system of international credit with gold-convertible claims resting as a much smaller base of gold itself. If the credit goes on expanding, and the fractional gold base becomes smaller and smaller, then the result would be an ultimate collapse of the system because every body would like to convert its claims into gold. Because of the absence of the facility of a lender of last resort by the Central Bank at the international bank makes the threat serious.

If gold's role is to be reduced, then some kind of International Banking facility to stand behind the Central Banks in much the same way as the Central Banks earlier stood behind commercial banks. We have made progress in this direction. The situation is not satisfactory because the control remains in the national units. What is required is not the end of the old facility of conversion into gold, but to improve the status of certain token claims between Central Banks.

Suggested Readings

1. C.P. Kindleberger : International Economics
2. Fred Hirsch : Money International
3. P.R. Brahmananda : The Gold-money Rift.

“One of the most striking lessons of international currency experience since the First World War is that countries which have sacrificed basic national objectives in order to maintain overvalued parities have suffered major economic losses and in the end have failed to maintain the parities.”

—Brookings Report on U.S. Balance of Payments, 1963

10

EXCHANGE CONTROLS

Q. Describe the circumstances which make it essential for exchange controls to be adopted.

Or

Discuss the difficult methods of exchange controls. Distinguish between Intervention and Restriction as methods of exchange control.

Or

How does the International Monetary Fund view the different exchange controls ?

Ans. Exchange control is part of the modern armoury of defences to shield a country's balance of payments from the full-rigors of the free play of markets, while its use can and often does point to a deficient and inflationary domestic financial policy, it is a legitimate instrument of insulation. Thus exchange control refers to Government's regulation of exchange rates and restriction of conversion of the local currency against foreign currency. Exchange control may be enforced under differing circumstances as follows :

- (i)** When the normal mechanism of the free exchange market may not be desirable or effective from the view-point of Government concerned.
- (ii)** When a heavy run on the country's foreign reserves occur because of adverse balance of payments or outflow of capital occurs in the expectation of a depreciation.
- (iii)** When the purpose is to increase the level of employment by encouraging home industries, exchange controls may be used to reduce imports.
- (iv)** When the purpose is to secure an adequate amount of foreign currencies to buy essential foreign goods. This type of situation arises in wartime.

- (v) Exchange controls may be adopted to freeze the assets of foreign nationals so that they might not be able to use them to help their own countries.
- (vi) Exchange controls may be adopted by a country to overvalue or undervalue its exchange rate or to avoid fluctuation in the exchange rates. A country may fix higher exchange rate and maintain it at that level, if it has to import foreign goods cheaply or if it has to make payments to others in foreign currency. Under-valuation of currency is undertaken if the purpose is to export more and to curtail its imports. Exchange control may be used to avoid fluctuations in the exchange rates due to speculative forces or erratic movements of short-term capital.

Lastly exchange control is a necessity in the planned economy. Foreign exchange control is one of the vital control mechanisms in the hands of the Government to secure necessary modification in economic scene in the country.

Methods of Exchange Control

Paul Einzig in his book "Exchange Control" has indicated 41 different methods of exchange control. Broadly these may be classified into two groups—direct and indirect methods. The direct methods consist mainly of intervention, restriction and exchange clearing agreements. Indirect methods of exchange control consist of quantitative restrictions on international trade like tariffs and quotas and interest rate changes to influence the rate of exchange.

Intervention

Usually the Central Bank on behalf of the government exercises control over and regulates the foreign exchange market. For effective control, this hold of Central Bank on foreign exchange market must be effective and complete. Central Bank should be the only source of foreign exchange and all buying and selling of foreign exchange should be undertaken by a single authority. Only then the Central Bank can adjust the demand and supplies of foreign exchange according to the needs of the country.

Pegging operations. Government intervention in the foreign exchange market takes the form of "pegging up" or "pegging down" the currency of the country to a chosen rate of exchange. The pegging operation takes the shape of buying and selling of the home currency either by the government or by the Central Bank of the country in exchange for foreign currency in the foreign exchange market. An example will illustrate it.

The Government of India fixed the exchange rate of the rupee at 14 cents a dollar in 1967. In a free exchange market, this exchange rate might fluctuate depending upon demand and supply of the rupee in terms of dollars. Suppose the foreign demand for rupee was far greater than

Indian demand for the dollars ; the exchange rate of the rupee would go up—say to 20 cents. If the Government of India was interested in pegging or fixing the exchange rate at 14 cents it would offer to sell rupees to any one at the official rate of 14 cents for a rupee. So long as the Government was prepared to sell rupees at 14 cents, the market rate of exchange could not go beyond this. Similarly if the foreign demand for the rupee was less and the Indian demand for dollars was more, the rate of exchange would go against India—say 12 cents per rupee. To prevent this fluctuation and to peg up the exchange rate to the original chosen rate of 14 cents, the Indian government should be prepared to sell foreign currency against the rupee at the fixed exchange rate. So long as the government was prepared to do so, the market rate of exchange would not fall below the official exchange rate.

Thus, buying and selling of foreign currency against the local currency with the definite objective of maintaining an exchange rate—whether the rate is over-valued or under-valued is known as pegging operation. If pegging operations are carried on by the Government or its agent, Central Bank, to maintain the exchange rate at a higher level, they are known as “pegging up” operations. If they are done to keep the exchange rate at a lower level, they are termed as “pegging down” operations.

Effects of Intervention. Intervention of the Government in the foreign exchange market has the effect of neutralising the forces of demand and supply of foreign exchange. Intervention can be effective when the government possesses sufficient reserves of local and foreign currency. So long as the market forces of demand and supply persist against the exchange rate fixed and maintained by the government, buying and selling operations would have to be continued. In case the reserves fall short of the required selling or buying operations, exchange rate cannot be maintained by pegging operations. Other direct measures like restriction may be resorted to.

In the inter-war period, Exchange Equalisation Funds were established in England, France and the U.S.A. with the definite purpose of maintaining the rate of exchange of their respective currencies at a fixed level. Experience of these Stabilisation Funds showed clearly that their success would depend upon the amount of foreign exchange reserves they possessed (local currency could be easily increased by printing more notes). Unless these were quite sufficient, it was difficult to peg up a currency when market forces of demand and supply were working towards a lowering of the exchange rate. Government intervention—pegging up and pegging down operation—is generally a temporary expedient to remove fluctuations in the exchange rate.

Restriction

Exchange restriction refers to the policy by which the Government restricts the supply of its currency coming into the exchange market. It may be of three types. The first method consists of centralising all

trading in foreign exchange in one central authority, normally the Central Bank of the country. The second consists of preventing the exchange of national currency against foreign currency without the permission of the government. The third method is to make all foreign exchange transaction through the agency of the government.

Exchange restrictions were first introduced in Germany in 1931. Non-compliance carried the death penalty. Other countries also followed German example.

Exchange restrictions may lead to the rise of blocked accounts. All those who have to make payments to any foreign country will have to make the payment not to the foreign creditor directly but to the central bank of the country which will keep the amount in the name of the foreign creditor. The amount will not be available to the foreigner in his own currency but can be used by him for purchases in the country practising exchange restrictions. This system is known as "blocked account". It is so called because the amount credited to that account cannot be converted into the creditor-country currency. It can lead to two types of reaction. Firstly, the foreigners whose accounts are blocked may refuse to export again to the country concerned. This type of reaction leads to less and less trade. Secondly, foreigners with blocked account will use all means, i.e., resort to selling at lower rates, to convert it into their own currency. This situation leads to black marketing.

The system of multiple exchange rates is a form of exchange restriction. It implies fixing different exchange rates for imports and exports and different rates for different types of commodities. The objective generally is to secure as good a price as possible for exports and reduce imports to the minimum. The advantage apparently lies in the enhanced power of the government to increase or reduce imports of any commodity by simply fixing a particular exchange rate for that commodity only. But this can also be interpreted as putting excessive power in the hands of government. That is why the International Monetary Fund has specifically advised its members to give up this practice.

Exchange control was first introduced in Britain in 1931, when the gold parity was abandoned and the government feared a disastrous collapse of the pound. The treasury issued a statutory order prohibiting the purchase of foreign exchange except for normal trading, existing contracts and reasonable travelling; but no control organization was set up. The order was revoked in 1932. In 1939, the legal position of the banks vis-a-vis their customers was protected by legislation under which authorized banks (which became the only organization permitted to deal in foreign exchange) acted as agents of the treasury; control was thereby decentralised. Germany employed thirty thousand people and had eight volumes of regulations. Here control was centralised and effective. She made the official banks redundant. On the other hand, Britain had to face many unnecessary loopholes.

Exchange Clearing Agreements

Exchange clearing is a method of exchange control which was practised during the depression of 1930's. Under it, two countries engaged in trade pay to their respective central banks the amounts payable to their respective foreign creditors. The central bank then uses the money in offsetting the corresponding claims after fixing the value of the currencies by common agreement. Assuming India having an exchange clearing Agreement with U.S.A., the Reserve Bank of India will open an account in the name of the Federal Reserve Bank of America. All Indian importers who have imported goods from America will pay in rupees to the Reserve Bank of India which will be credited to the account of the Federal Reserve Bank. At the same time all Indian exporters of goods to U.S.A. will receive payments from the Reserve Bank of India out of the account in the name of the Federal Reserve Bank. In the same manner the Federal Reserve Bank of America will provide similar services to American importers and exporters. All that happens is a notification by one central bank to another that a certain payment has been made or received. This system is essentially one of offsetting each others' payments and the basic assumption is that the countries entering into such an agreement will see that imports and exports are more or less equal and that there is no necessity for either making payments to or receiving payments from the other country.

The greatest advantage of these agreements is that import and export can take place without being unduly worried about the problem of finding scarce foreign exchange. Secondly, transactions 'do not pass through foreign exchange market and even a country without any reserve of foreign currency will be able to import goods from foreign countries. These are offset by certain disadvantages flowing from these agreements. There is the possibility of exploitation by a stronger nation of the weaker nation. Germany took full advantage of this system. Germany imported goods from many countries for which it could not pay in the currencies of foreign countries. Foreigners were paid in the German currency at the German Central Bank which blocked its conversion to foreign currency. Foreign governments were forced to enter into exchange clearing agreements with Germany and buy whatever goods Germany was able to offer in order to liquidate their blocked accounts. The second disadvantage lies in the fact that these agreements lead to bilateral trade at the expense of multilateral trade which normally diverts to abnormal channels. Finally, these agreements reduce the volume of trade.

Indirect methods consist of tariff duties and quotas and other quantitative restrictions on the volume of international trade. Import restrictions by tariff, etc., lead to the decline of demand for foreign currency. Assuming the exports to be same, rate of exchange moves in favour of the country imposing restrictions. Similarly a high rate of interest attracts short-term capital to the country (India) concerned. The demand for rupees rises in terms of other currencies, and a higher exchange rate for the rupee in terms of other currencies emerges. A lowering of the rate of interest will have the opposite effect.

The post-war payments code adopted by the members of the International Monetary Fund rules out the use of exchange controls for this kind of horse trading, by banning the use of exchange restrictions for normal trade and current payments. Under the I.M.F.'s Article VIII countries are obliged to allow free transfer and conversion of any holdings of their currency acquired by non-residents through the process of current trade. In addition, payments by domestic residents are to be allowed freely for imports or other current services.

Countries with large financial business may be hesitant to make the choice between control and devaluation since both are damaging. For countries whose currencies are not widely held internationally exchange control is a less tricky expedient. It involves neither the potentially damaging side effects nor the same possibilities of avoidance and evasion. But the efficacy of the exchange control will depend on the degree of determination of the controlled in getting through the net. The government which can appeal to patriotism, can succeed in imposing exchange controls effectively. Similarly a government which cannot appeal to patriotism, may find controls also less effective. The constraint will be strongest with a fixed exchange rate, above all with an overvalued rate. A flexible exchange rate gives some cushioning, and may be attractive for this reason. But in the face of major political or tax motivated or interest motivated capital outflows, a government intending to keep to its independent course may have to be prepared to countenance a very large exchange depreciation—which may carry the risk of spiralling out of control. The limitations of exchange control itself in protecting a weak currency are growing year by year, as the possibility of evasion grows with the enormous increase in personal and business travel, and with the sheer extent of public understanding of how these things can be done.¹

EXCHANGE RATE CHANGES AND THE BALANCE OF TRADE

Q. Explain the process by which changes in exchange rate influence the balance of trade.

Or

Discuss the immediate and induced effects of exchange rate changes upon the balance of trade.

Ans. Exchange rates alter due to several reasons. We assume such an alteration occurs in exchange rates. We further assume that prices within each country of all goods produced there remain unchanged. If foreign currency comes to cost more to home residents, then the home currency price of foreign goods rises, although the dollar price is unchanged. Similarly such a change makes home goods cheaper to foreigners.

The immediate effects of exchange rate changes :

A change in the price of a commodity affects its demand. Increased price leads to reduced demand and decreased price leads to an increase in

1. Fred Hirsch, *Money International* (Pelican Book Ltd. Harmondsworth, 1969, pp. 270-71).

demand. The relationship between changes in prices and changes in demand is measured by the elasticity of demand. It measures the ratio between a small per centage change in price and the associated per centage change in demand. A large elasticity means that a small price change leads to a big change in demand; a zero elasticity means that a small price change leads to no change in demand. When the elasticity of demand is equal to one the amount of money spent on purchasing the commodity is the same both before and after a price change, because the rise in the quantity purchased just counter balances the fall in price per unit.

The effect of an exchange rate change on the demand in each country for the other's goods and so on the balance of trade between the two countries can be summarized in terms of elasticities which represent the effect on the demand for the other country's goods of a small change in their price in terms of one's own currency (when everything else, including all other prices, remains unchanged). Each is a weighted average of all the individual demand elasticities for all goods imported by one of the countries (including goods that start to be imported when prices fall). It is concerned only with the proximate effects of the price changes on demand, and not with any indirect effects through such things as the changes in the level of activity which may arise from the changes in demand.

In the case where the balance of trade between the two countries is originally in balance, the relationship between the demand elasticities and the effects of an exchange rate change on the balance of trade is very simple.

1. If the sum of the home elasticity of demand for foreign goods and the foreign elasticity of demand for home goods is less than unity, the balance of trade moves against the country whose exchange depreciates.

2. If the sum of the two elasticities is greater than unity, the trade balance moves in the favour of the depreciating country.

3. If the sum is unity, the trade balance remains unchanged.

The above can be expressed in the form of a formula. The percentage change in the balance of trade directly arising from a depreciation by 1 per cent is

$$(\epsilon_n + \epsilon_f - 1)$$

(Where ϵ_n is the home consumer's elasticity of demand for foreign goods, and ϵ_f is the foreign consumer's elasticity of demand for home goods). This rule, however, applies only for very small changes.

From the above, we can break up the consequences of a 1 per cent depreciation into three parts : (1) The volume of imports are affected by ϵ_n per cent (For example, if say $\epsilon_n = 3$, we are simply saying that a 1 percent devaluation leads to a 3 per cent decline in the quantity of imports demanded). (2) Volume of export rise by ϵ_f per cent in the case of a 1 per cent devaluation. (3) Price of exports are affected : a 1 per

cent depreciation means a 1 per cent fall in the price of exports, and therefore, a counter balancing 1 per cent decline in foreign currency receipts. Here then are the three elements ; rises in the net foreign currency receipts after a 1 per cent devaluation of $(\epsilon_n + \epsilon_f)$ per cent, and a counter balancing fall of 1 per cent because of the fall in the price of exports as expressed in terms of foreign currency.

Two complications should be taken account of. We assumed that trade is initially balanced. This does not happen usually. Depreciation generally occurs when the initial position is one of disequilibrium. In this case the simple rule no longer applies for two reasons. The critical sum of elasticities will be between zero to two, it will not be unity. Moreover their sum is no longer the same for the change in the balance of trade measured in home currency and in foreign currency.

Secondly, the change in exchange rates alters the relationship between export prices and import prices in each country. This change is known as a change in the terms of trade ; an improvement of the terms of trade occurs when the terms upon which imports can be obtained in return for exports improve ; that is when import prices fall relatively to export prices. The terms of trade always move against the depreciating country by the same percentage as the exchange depreciation ; exports are unchanged in price in terms of home currency and imports rise by 1 per cent for each 1 per cent of exchange depreciation. In the depreciating country where import prices rise, real income is lower if output is unchanged. Correspondingly there is a rise in real income implicit in the fall in the import prices in the other country. This affects expenditure plans and thereby affects the critical value of the elasticities.

The Induced effects of Exchange Rate Changes.

We assume that trade was initially balanced and that the terms of trade have no effect on total expenditure from a given money income.

If the sum of the import demand elasticities in the two-countries is greater than unity, the switch effect tends to cause a balance of trade surplus in the depreciating country and a balance of trade deficit in the other country. This leads to an expansion of activity in the depreciating country and a contraction in the other.

If the sum of import elasticities equals unity, then the balance of trade remains unchanged in each country. In the home country the value of exports and the value of imports rise by an equal amount. Since saving out of given money income is (assume) unchanged, the rise in the value of imports involves an equal reduction in the amount of home expenditure on home-produced goods. Therefore, total (home and foreign) expenditure on home produced goods is unchanged, and neither a multiplier expansion and nor a multiplier contraction is induced.

If the sum of the demand elasticities is less than unity there is a deterioration in the balance of trade of the depreciating country, which

tends to cause contraction in its level of activity. Similarly the switch effect in these conditions tends to cause internal expansion in the appreciating country.

In the final equilibrium, the country with the proximate improvement in its balance of trade finds it still has an improved trade balance; but the improvement is less than proximately, because its level of activity is higher. Similarly the other country finds itself with a worsened trade balance (though less than proximately) and a lower level of activity.

There occurs a change in the character of output in each country as an induced effect of exchange rate change. In each case the change in imports probably affects certain industries particularly sharply—these can be called import competing industries. Thus an exchange rate does lead to disturbances and adjustments even if the total level of activity is unaltered, as some industries may be expanding and others may be contracting. Secondly, the income redistribution which is involved, with producers of export and import competing goods becoming better off in the depreciating country and worse off in the appreciating country, relatively to producers of other goods) may affect savings and investment plans and so in turn may induce changes in the general level of activity.

Limitations of the Elasticity Analysis.

Two limitations should be kept in mind : (1) The analysis is valid only when exchange rate changes are very small. (2) Size of the demand elasticities cannot be precisely estimated. There are two reasons for it. Firstly, considerable statistical problems are involved. Secondly, elasticities tend to be bigger in the long run than in the short because there is time for producers and consumers to adjust to new relative prices.

Despite these difficulties, reasonable guess can be made about the magnitude of demand elasticities and consequent changes resulting from an exchange rate change can be analysed provided there are no changes in internal price levels in either country.

Suggested Readings

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| 1. A. C. Day | : Monetary Economics. |
| 2. S. C. Nandwani | : Trade Dilemma of Developing Countries. |
| 3. Fred Hirsch | : Money International. |
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EXCHANGE DEPRECIATION

Q. Examine exchange depreciation as an instrument to correct an adverse balance of payments.

Ans. If a country is on free exchange rates, exchange depreciation is used as an instrument to correct an adverse balance of payments. Exchange depreciation signifies a decline in the rate of exchange of one currency in terms of another. Assuming that the rupee exchanges for 14 American cents, India suffers an adverse balance of payments with regard to the United States. Then Indian demand for American currency rises. Consequently Indian rupee depreciates in value and American dollar appreciates in value, the rate of exchange may become 10 cents per rupee.

The first consequence of such a situation is that American goods become expensive and a decline in Indian demand for American goods is likely. Similarly Indian tourists will spend less in the United States. A similar reduction occurs in certain other items. However, depreciation of rupee stimulates exports from India because (1) Indian currency being cheap, Indian goods are also cheap for Americans and more are bought by Americans, (2) Indian exporters become interested in increasing exports because each dollar earned abroad gets a larger amount of rupee than before.

The result is that imports are checked and exports are stimulated. A favourable balance emerges to correct the earlier deficit in the balance of payments. Exchange depreciation is automatic and corrects a mild adverse balance of payments. The amount of depreciation necessary to correct an adverse balance of payments will depend upon the elasticity of demand for imports and exports. If the demand for imports is elastic (goods may be luxuries and comforts) a slight exchange depreciation, raising the price of foreign goods, will be sufficient to correct the adverse balance of payments. The effects will be magnified if the foreign demand for exports is elastic. On the other hand, if exports and imports consisted of necessities and the demand for them is inelastic, it will not be much affected by the rise or fall in prices and hence a higher degree of exchange depreciation will be essential.

The defects of exchange depreciation are serious. (i) This is not suitable for a country wedded to fixed exchange rates (ii) Exchange depreciation makes international trade risky and hence it reduces its volume. (iii) The terms of trade, i.e., the rate at which exports exchange for imports—will go against the country whose currency depreciates in value. (iv) Exchange depreciation, sometimes, raises money incomes by raising prices. Costs in export industries may rise while imports may rise on account of increased incomes and import substitutes are expensive. As a result adverse balance of payments will intensify, the rate of exchange will continue to depreciate till such time when its value will be almost nothing—i.e., when the stage of hyper-inflation is reached.

Depreciation should be distinguished from devaluation. Depreciation stands for automatic reduction of the value of a currency by market forces, devaluation is the reduction of the value of currency undertaken by the Government. But in substance both mean the same thing: lower value for the local currency in terms of foreign currencies. Effects of both are similar. When the local currency depreciates and the foreign currency appreciates in value, the foreign commodities are made costly. Consequently imports are checked. But the local currencies are made cheap and hence exports are promoted. Thus a tendency towards a favourable balance of payments is created.

DEVALUATION

Q. “But, unfortunately, devaluation in no way helps the developing countries to improve their balance of payments situation.” Discuss.

Or

Examine the impact of devaluation upon the balance of payments situation of developing countries by making use of the elasticities analysis and the absorption approach.

Ans. Devaluation of the currency is often suggested as a remedy to rectify the fundamental disequilibrium in the balance of payments position of a country. Developing countries are facing this fundamental disequilibrium in the balance of payments for various reasons: their dependence on the export of primary products only, needs of economic development to import machinery, equipment and even food, and the inflationary pressures within the economy may be listed as the most important of them, which account for the rapid rise in the imports and comparatively sluggish growth of exports, resulting into imbalance. Under conditions of such a disequilibrium, exports are discouraged since they cannot stand the competitive international prices and it pays to sell in the domestic market. Imports are encouraged because foreign goods happen to be cheaper. It creates adverse movements in the balance of payments position. Two monetary solutions are possible to rectify this imbalance. First is to reduce the cost of production by bringing about a general squeeze in the money supply. It results into a general fall in the level of prices, output, income and employment much detrimental to the interests of a growing economy. It, however, might improve the balance of payments situation as a short-term remedy but will not be in the lasting interest of the country. Second is to

devalue the currency. The consequences of devaluation vary not only from country to country but also from commodity to commodity and it is difficult to foresee the net effects on the balance of payments, unless we have a detailed analysis of various factors influencing it.

Whatever may be the reasons for the fundamental disequilibrium in the balance of payments situation of a country, it is reflected in the continuous decline in the exports and increase in the imports. Devaluation for example, of rupee, raises the price of foreign goods in rupees, restrains imports and lowers the price of domestic products in dollars, thereby encouraging exports. The adjustment of this nature might not work in the case of extremely inelastic demand. With the total value of domestic exports reduced more than that of the domestic imports, may even call for further devaluation.

The Elasticities Analysis

Devaluation provides impetus to exports depending on foreign elasticity of demand for these products and the elasticity of supply of exports from rival exporting countries. With the inelastic supply of exports from the rival country, the effects of devaluation will be neutralized by the price cut of its own. Exports, however, will increase only if the price elasticity of foreign demand for the products in question is higher. Elasticity of supply of the rival producer matters significantly only in the cases of products which are very competitive and where a country produces major share of the world market. On the other hand, if the world demand for exports happens to be inelastic, devaluation of one currency will not encourage its exports. Devaluation may increase the volume of demand for exportable goods but, it at the same time reduces the foreign price of exportables and with the elasticity demand less than one, a fall in the exchange rate of 40 per cent may be followed by an increase in the exports by say, 30 per cent. Thus there may be an increase in the volume of exports by 30 per cent, while the actual value of receipts may be lower than those prevailing hitherto before the devaluation. Thus price declines may more than offset the effects of increase in the exports. It may not result in the apparent reduction in the output but certainly in the level of income and may have long run detrimental effects on the level of output as well.

As for the imports are concerned devaluation would be beneficial to a country, when the elasticity of home demand for imports is high, i.e., when a given rise in the value of imports measured in home currency causes a more than proportionate fall in the volume of imports. But when the elasticity of demand for imports is low it will entail fall of imports more than the one before the devaluation period.

Thus, devaluation may improve the balance of payments if the elasticity of demand for exports and imports happens to be high while the elasticity of supply of exports and the supply of imports happens to be infinite. But in the short period, over all elasticity of supply has to be, of necessity, inelastic, unless there are considerable untapped resources.

And instead, the volume of exports can rise only at the expense of a cut in domestic consumption. But in the long run, the favourable effects on exports may not be dependent only on the domestic absorption, as a long run period permits changes in the scale of the plant. And this might encourage a reallocation of resources in favour of exportables, since the prices of exportables will tend to be higher than the prices of other goods. Profit margins will again encourage the entrepreneurs to shift resources in favour of exportables.

The elasticity analysis has been subjected to good deal of criticism by Alexander and Pearce. According to them, elasticities of demand and supply may not be able to reveal their full impacts on the exports and imports, since they are not independently specified. They are a composite whole depending upon so many variants and constraints such as, given other prices and given national incomes. But the prices of other things and national incomes do not remain invariant. Hence it is impossible to indicate as to how imports and exports respond to a change in their prices.

The Absorption Approach

The absorption approach is also called the saving and investment approach to devaluation. According to this approach, the volume of exports can rise only if a certain amount of disabsorption takes place within the country as a result of devaluation. This can come about only if the domestic real spending on exportables is reduced. Devaluation would bring about an improvement in the balance of payments situation if it increases the country's total income relative to the absorption or decreases the absorption relative to the output or income. Protagonists of this approach believe that devaluation results into disabsorption as prices rise in face of the constant total money incomes. Thus a shift in the distribution of income from wage earners to the entrepreneurial class, on account of increase in the profit margins, will involve cut in spending. But this may not be sufficient to bring about a requisite change in the balance of payments situation, as part of disabsorption may be required to finance the imports which now cost more. The policy of contrived disabsorption is also suggested to bring about the desired results. Thus the real elasticity of supply of exports will be to a greater extent dependent on the amount of disabsorption that accompanies a devaluation. Again, it is suggested that untapped resources will be put to productive use as a result of devaluation.

Since devaluation makes foreign goods and services more expensive relative to domestic products it reduces the real buying power of the people and leads to disabsorption. Further, devaluation reduces the total real value of cash balances. Entrepreneurs, of necessity, have to reduce their consumption and investment or absorption in order to maintain the level of cash balances in proportion to the real income. But the other possibility of an increase in the absorption cannot be ruled out as a result of an increase in prices if some inflationary expectations creep into the economy.

Devaluation, it appears, would do little to correct the deficit if we try to minutely analyse the absorption approach. A shift in the distribution of income perhaps towards the profit at the expense of wages may not be able to bring about the requisite amount of disabsorption. Moreover, a policy of contrived disabsorption may not find favour with most of the economists. Devaluation, in order to bridge the deficit, must either reduce investment or increase savings or both. Cut in investment seems to be unlikely and savings can be raised only by raising real incomes. But devaluation may not be able to bring about the increase in the real income or output at full employment level.

Elasticities analysis and the absorption approach, though try to look at the issue of devaluation from two different stand points, yet dispel the same "devaluation pessimism". Elasticities analysis is more concerned with the relative prices and ignores the issue of absorption as some proportion of total income or output. Absorption approach deals mainly with the propensities to consume, save or invest and does not take into consideration the changes in relative prices. Nevertheless the two approaches do not deviate much regarding their conclusions.

Devaluation and Developing Countries

Developing countries, without exception, are to-day facing adverse balance of payments. Most of these countries have devalued their currencies to rectify this adverse situation. But unfortunately, devaluation in no way helps, the developing countries to improve their balance of payments situation. It is the least powerful and dependable device from whichever angle it is analysed. Devaluation is unlikely to add to the exports of developing countries. It could hardly improve the export prospects of Indian tea. India and Ceylon are two major exporters of world tea and any attempt made by India to enlarge her share of the world market has been resisted by Ceylon. Although, Ceylon decided not to devalue her currency, yet a close watch is kept so that her interests do not suffer in the world market for tea since it accounts for 60 percent of the export earnings of that country. Thus with the relative inelastic world demand for tea, any attempt to increase the relative share through devaluation may well lead to a fall in the export prices without a proportional rise in the exports. Devaluation might help India to safeguard her tea exports from falling still further. There is a lower elasticity of demand in the world market for Indian jute goods. And there is greater elasticity of supply of competitive jute industry of Pakistan which also happens to be technically in a better position than the Indian jute industry because of the greater availability of raw jute and relatively new machinery. Under these circumstances it is doubtful if devaluation will maintain the export earnings from jute industry. Devaluation may help in a marginal way to improve the export prospects of industries which are otherwise finding a relatively elastic world market. There may be certain export of new products which are of the marginal nature and given the elastic supply of these exports, the effects will be favourable.

The same may be true when we consider the absorption approach. In a developing country, it is very difficult to make a cut in consumption in order to raise the exportable surplus, when the consumption standards are already much near the subsistence. And the policy of contrived dis-absorption under such circumstances is sure to be resisted unless an institutional change is brought about. The argument that untapped resources in the developing countries are bound to result in greater output when put to productive use as a result of devaluation, seems to be dubious. Firstly, there are not very many untapped resources in the developing countries. Secondly, internal bottlenecks in these countries do not permit the proper use of untapped resources. Devaluation thus may not be quite effective in bringing about a relative increase in the output. Further this increase in output may be completely into an increase in consumption and investment. And, finally, developing countries are more or less, out of sheer necessity, to follow the cheap money policy. Thus people, may not quite often indulge into disabsorption in order to maintain the same real value of cash balances. Absorption might, in fact, increase as a result of inflationary expectations. Again, change in distribution of income from the wage earners to the profiteers will not work without other detrimental effects in an already non-equalitarian set-up.

DEPRECIATION AND THE TERMS OF TRADE

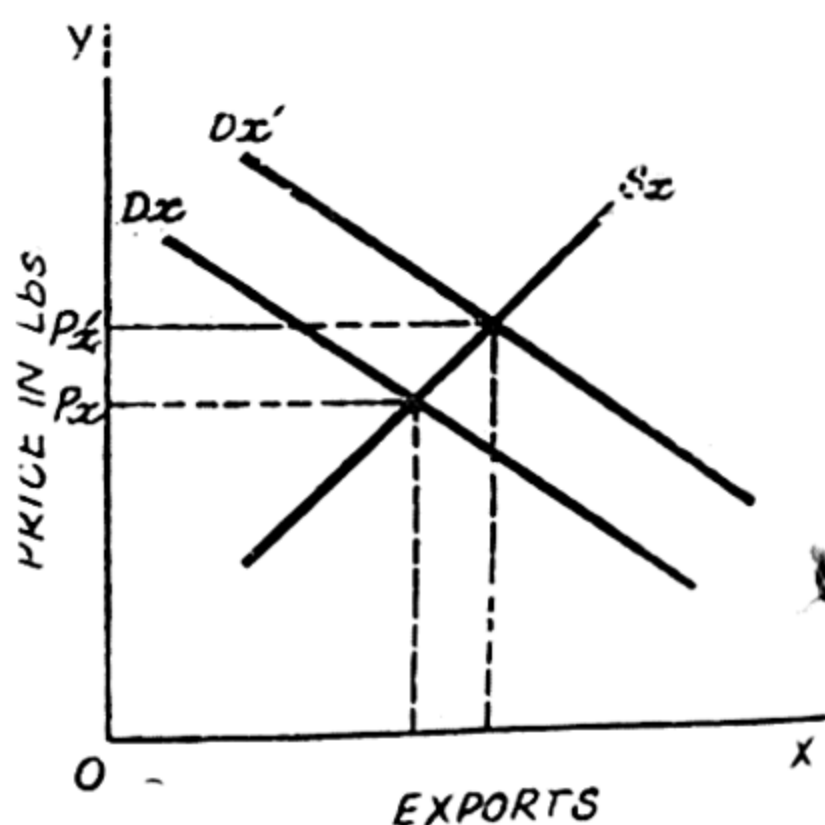
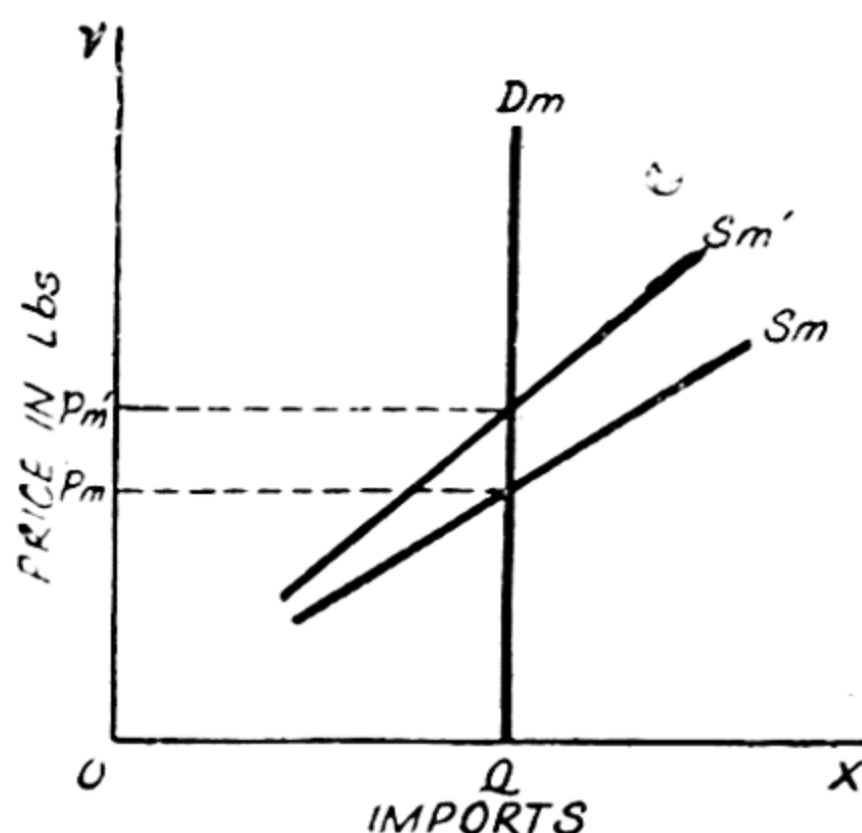
At first glance, a depreciation of one's currency would lead to a deterioration in the terms of trade, because import prices will rise and export prices will fall. This is not necessarily so, however, because when measuring the terms of trade we must stick to the measurements of prices either in term of foreign currency or the domestic currency. Thus with depreciation, import prices rise in domestic currency, but stay unchanged in foreign currency; export prices fall in the foreign currency but stay unchanged in domestic currency. However, taking account of secondary effects (e.g., higher costs of raw material imports into the depreciating country) it is probably more correct to say that depreciation will raise the domestic currency price of both imports and exports. Similarly, the foreign currency price of both imports and exports will tend to fall. Thus, which way the terms of trade go will depend on the relative sizes of the price changes, given that both will move in the same direction.

To determine the direction of change in terms of trade, we must consider the forces which in turn determine the sizes of the relative price changes of imports and exports, i.e., the elasticities of demand and supply for exports and imports. Joan Robinson has analysed the role of elasticities and has shown (expressing prices in terms of the depreciating country's currency) that depreciation will worsen the terms of trade if the product of the supply elasticities is greater than the product of demand elasticities. Although the method of proving this is somewhat complex, it is relatively simple to demonstrate the importance of demand and supply elasticities.

Suppose, for example, the demand of the depreciating country for imports were perfectly inelastic and the demand for its exports were

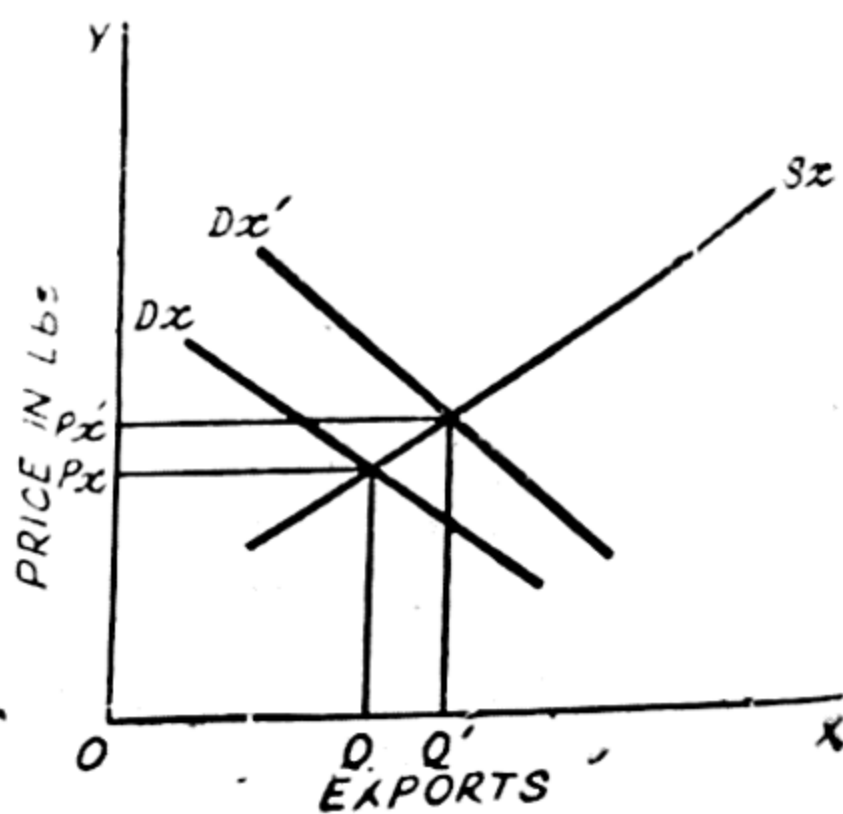
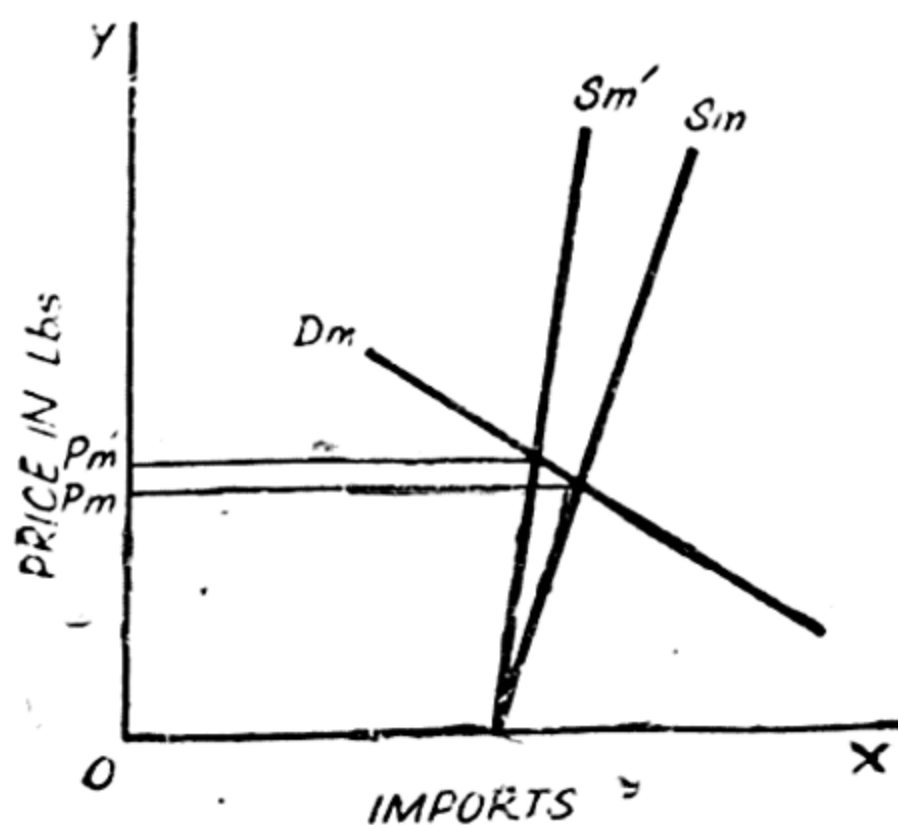
elastic. On the supply side, suppose that the supply of imports to the depreciating country were elastic and the supply of its exports were also elastic.

The situation is as shown below. Before depreciation, the prices of imports and exports are OP_m and OP_x . Now let the currency depreciate



by 10 per cent, then the supply curve of imports will shift upwards S'_m , and the demand curve for exports shift outwards to D'_x ; giving new equilibrium prices of $OP_{m'}$ and $OP_{x'}$. The prices of imports will have risen by a greater percentage amount than the price of exports ($\frac{P_m \cdot P_{m'}}{OP_m} > \frac{P_x \cdot P_{x'}}{OP_x}$) and so the terms of trade will have deteriorated. (Also note that the product of supply elasticities is greater than the product of demand elasticities).

Suppose on the other hand, that the demand for imports were elastic and the supply of imports were very inelastic, the supply and



demand elasticities for exports remaining unchanged. In this case the price of exports rises proportionately more than the price of imports and the terms of trade improve (the product of supply elasticities is less than the product of demand elasticity).

We can see, therefore, how important demand and supply elasticities are in determining the direction in which the terms of trade move.

The above analysis is too simple, however in that it takes no account of income changes brought about by depreciation, or of importance of the cross elasticities of demand. Depreciation may cause relative price differences to emerge between traded and non-traded commodities, with the result that the demand for imports may shift due to the effect of cross elasticities. Also, real incomes may change as a result of these price changes and this, in turn will affect the demand for imports. Because of these repercussions, the final elasticities may differ from the partial ones used here.

More information is required before conclusion regarding welfare changes can be reached : information concerning changes in the volume of trade, changes in the quantity of goods traded, changes in productivity, changes in other sections of the balance of payments and so on.

DEVALUATION AND THE PRICE LEVEL

Advocates of exchange rate flexibility claim that devaluation normally has a deflationary influence on domestic prices. This is based essentially on the 'welfare' effect of improving allocation of resources and efficiency within the economy. This should indeed be the result of the mere substitution of devaluation for protective controls. However, if devaluation is intended to eliminate a deficit (controls have not been successful in eliminating the deficit) then elimination of the deficit itself will be an inflationary influence, withdrawing goods from the home market.

In addition to this demand inflationary influence, rise in imports prices in domestic currency will add to cost inflation. This will lead to price-wage-price spiral and devaluation leads to inflation. If curbs are imposed on demand inflation, rise in costs is likely to be less because import prices do not rise in proportion to devaluation. The increase in costs as a result of increased domestic import prices is more serious for a small country which imports more but the absolute size of her imports remains small because of her size and thus gives her smaller leverage over world prices. Therefore small countries feel hesitant in adjusting their payments through variations in their exchange rates.

Thus if a small country's economy has high foreign trade content, devaluation is likely to be much more disruptive for domestic prices. This also implies that the country conceived can achieve a much larger and quicker effect on the trade balance by changes in domestic spending, i.e., by deflation or reflation, since as much of that spending goes abroad through the trade balance as stays at home. Thus it would follow that

the more a country is dependent on foreign trade, the less she should make use of exchange rate and vice-versa.

The risk of similar response on the part of other countries is very real in the case of devaluation. A big country finds it more difficult to increase her market share. She faces lower export elasticities of demand than smaller countries exporting the same products. Thus her vulnerability to retaliation is increased. Besides, her currency may be used as a reserve currency. This makes her reluctant to resort to devaluation. Though, her big size and small content of foreign trade in her economy may provoke her to resort to devaluation.

In post-war experience with relatively few alterations in exchange rates among middle sized industrial countries the device has worked fairly well. There have been no perverse elasticities and inflation has not got out of hand where appropriate domestic steps have been taken. The revaluations by Germany and Holland in 1961 were both eventually followed by disappearance of chronic surpluses. The devaluation by France in 1958 and by Canada in 1961-62 both resulted in a marked upturn in economic fortunes : in both cases they were accompanied by a marked improvement in domestic economic management. The biggest post-war round of devaluations, in 1949, was unquestionably a success for Europe as a whole. It helped turn the dollar shortage in dollar glut. But for Britain, who initiated devaluation, it amounted to failure. The Korean War complicated the situation. It would have been better for Britain to postpone devaluation upto 1952. French devaluation of 1936 failed because of the failure to hold inflation in check and the failure to follow correct policies.

Historically majority of the devaluations have been a failure, getting caught up in self-defeating inflationary spirals. For the bigger countries, at least in modern times, they have mainly worked.

DEVALUATION AND THE DEBT BURDEN

The overseas investment balance sheet is an extra complication in any exchange rate assessment. If the foreign debts of a country have been guaranteed in foreign currency, their servicing will represent a fixed charge on the economy. Their foreign currency cost cannot be reduced by devaluation. The debt servicing will be equivalent to imports with a zero elasticity of demand ; however much the domestic price of the debt servicing goes up, as much foreign currency will be needed as before. In this way, the foreign debt will cause a special deterioration in the 'gross barter' terms of trade, that is in the physical quantity of exports needed to pay for a given quantity of imports. Devaluation will become more dependent on favourable elasticities in community trade.

If these elasticities are sufficiently high, then devaluation may make servicing and the repayment of the debt easier, and accordingly less of a burden on the economy as a whole. Once a given foreign currency obligation is increased, the real burden of repaying it may or may not be

increased by devaluation. This burden can be measured only by the domestic resources that have to be given up indirectly as well as directly to earn the additional foreign currency when this is eventually repaid.

The existence of large overseas assets in domestic currency may be a deterrent to devaluation. Here the additional burden does come in terms of foreign currency, as the overseas debtors need to give up less of their own currency in order to service or repay the credits ; while the foreign currency liabilities burden is in terms of additional domestic currency handed over to the foreign creditors. Income from foreign assets, is comparable to exports with a zero elasticity of demand, A zero elasticity of demand for exports reduces actual external receipts ; while a zero elasticity for imports (merely) prevents a reduction in external spending.¹

If the use of national currencies in international reserve is an overriding priority, this goes against exchange rate flexibility. However it can be stated in the other way ; the case for building an element of exchange flexibility into a continuing system, rather than relying on last-resort adjustments which risk wholesale exchange crises, itself provides perhaps the most powerful argument for amending the position of the reserve currencies. And once exchange rate variations were made part of the norm, the connotation of default and expropriations in relation to privately held balances (which also build up effective devaluation reserves through over the odds interest earnings) would surely diminish too. The chances of an exchange rate change would be a normal market factor to be reckoned with openly—especially as rates would move up as well as down.²

Suggested Readings

- | | | |
|-------------------|---|--|
| 1. S. C. Nandwani | : | Trade Dilemma of Developing Countries. |
| 2. Fred Hirsch | : | Money International. |
| 3. A. C. L. Day | : | Monetary Economics. |

1. Fred Hirsch, *Money International*, (Hasmondsworth, Penguin Books Ltd., 1969, pp. 411-412).

2. Fred Hirsch, *Money International*, pp. 418-419.

THE TRANSFER PROBLEM

Q. Enunciate and explain the transfer problem and analyse the mechanism of unilateral transfers. *Or* (Nagpur, 1962)

Indicate the adjustments involved in the unilateral transfer of funds and point out the nature of the transfer problem. (Delhi, 1962)

Or

Describe the mechanism of unilateral transfers and bring out the role of income changes in the process.

Ans. Borrowing is necessary when a country tries to get capital without saving. Capital is obtained from abroad in the real sense only when goods and services are obtained over and above the value of the country's exports. A country lends abroad when it produces more than it consumes and invests at home, the difference representing excess of exports over imports. The borrower is interested in the purchasing power in his own country. This is known as the money transfer. But how this money transfer, in term, leads to an import surplus, which is the only real way that capital can be loaned between countries, is called the real transfer. The money and real transfers are inter-related.

THE CLASSICAL MECHANISM

Classical economic theory provided different answers to the transfer problem under gold standard and fluctuating exchange rates. Under the gold standard money borrowed in London was sold for dollars. This depressed the pound sterling to the gold export point and led to a gold inflow to the borrower, i.e., the U.S.A. Prices declined in England as a result of the contraction of money resulting from the gold outflow. Conversely prices rose in the U.S.A. because of the increase in the means of payment. If bank-rates were raised in England to halt the gold outflow by attracting short-term capital, contractive process would still take place, though probably on a reduced scale. But the loss of the gold or the inflow of short-term capital in the lending country, plus the increase in interest rates would be contractive and depress prices. In the United States, the gain of gold or of short-term claims on London, the expansion of the money supply, and lower interest rates, all work to raise prices.

Assuming the sum of the price elasticities of demand to be greater than one, lower prices in England would produce an export surplus there, and higher prices in the United States would produce import surplus. This is the real transfer.

The real transfer in goods reverses the original movement in gold a subsequent short-term movement. As British exports exceed imports, gold returns to the Bank of England and she repays the short-term capital borrowings from New York. This decline in prices in England and rise in prices in the United States will change the terms of trade in favour of the borrower and against the lending country during process of transfer ; but when real transfer has been completed, the terms of trade will revert to their original status.

and
Under the paper stand, the classical view of the transfer process is as follows : The attempt by borrower to sell pounds for dollars leads to a depreciation of the pound, in the absence of stabilizing short-term capital movements. The depreciation of sterling and the consequent appreciation of dollar encourage the lender's exports and borrower's imports and discourage the borrowers exports and lender's imports. As Britain develops an export surplus, the original borrower buys the dollars he needs for expenditure in the United States. Money transfer and real transfer take place simultaneously. When all the funds (capital) have been transferred from London to Newyork, the export surplus of Britain vanishes and the depreciation of sterling is corrected, as the demand for dollars is reduced and the export surplus of Britain creates a demand for sterling which can be satisfied only at a higher rate. The short-term capital movements act like the gold movement, though with reduced certainty and intensity, and raise prices in the United States and lower them in Britain. Whether short-term capital movements take place or not the term of trade normally turn against the lending country as a result of transfer.

Three objections were made to the transfer process under the gold standard. Firstly, some of the proceeds of loans might be spent in Britain. Consequently real transfer takes place automatically with no money transfer affected. Secondly, it was pointed out that prices could not be raised in the United States and reduced in Britain, since a number of goods were traded in both, and the law of one price required that they be quoted at the same price in a single market. However, this objection was in error. Thirdly, the objection related to the reliance on the quantity theory of money. In the short run, the quantity of money was little indication of the level of prices. Thus changes in money could occur without bringing about changes in spending, and changes in spending sometimes affect employment without producing changes in price.

However, the real flow of the classical theory lay in the fact that the transfer process in the real world worked for more smoothly than are could have imagined from the classical mechanism. The balance of payments adjusted itself to changes in borrowing (or vice versa) with

remarkable speed and precision and without market pressures leading to gold flows or exchange rate changes.

Modern Theory

The classical theory neglected the changes in spending and income and their effects on the balance of payment through the marginal propensity to import. Transfer took automatically when borrowers spent part of the money in the lending country and the marginal propensity being one. But on the portion of the loan spent at home the increase in domestic expenditure raises income which spills over into imports, and this transfers part of the loan. How much of the loan will be transferred in this fashion depends upon the marginal propensity to import and save in the borrowing country, the course of money income in the two countries, and the response, if any, of domestic investment.

It has been enunciated as a theorem that if the marginal propensity to save in the borrowing country is positive and if domestic investment in the borrowing country is changed by no more than the amount of the loan, with no induced changes in investment in either country, changes in income in the two countries will not be sufficient to transfer the whole loan through induced changes in imports.

Considering the variability introduced by several assumptions, it may be impossible to make any general statement about the extent to which income changes can transfer theoretical international capital movements. However, it may be concluded that income changes are likely to transfer normal capital movements smoothly, and from the German reparation experience, that some capital transfer will be very difficult to effect.

In summary form, it may be stated that international capital transfers in money may be transferred in goods through income changes, in part, in toto or in excessive degree (i.e. a larger real transfer than the original money payment) and that real transfer will be fully or excessively affected, the greater the extent to which other things being equal,

1. Spending and income fall initially in the lending country in the process of raising the money capital.
2. The loan is spent by the borrowers in the lending country.
3. Money income rises in the borrowing country, due to :
 - (a) A low marginal propensity to save,
 - (b) A positive marginal propensity to invest,
 - (c) In the case of reparations, a readiness to reduce taxation or increase government investment, or of domestic investment or consumption to respond upward to a reduction in government debt.
4. The foreign repurcussion of both countries is low.
5. The banking systems of both countries respond to the movements of short-term capital and gold.

Conversely, the less that the above conditions are realized, the greater is the likelihood that the capital will not be fully transferred through income changes arising out of the capital transfer itself, under the circumstances, gold flows will be needed on the gold standard, which may induce income changes of a banking origin ; or an exchange rate adjustment will be needed to accomplish the remaining transfer through price changes.

Effects of International Capital Transfers on the terms of trade.

The transfer considered can take the form of a grant, an interest payment, war reparation, a loan or loan repayment. Problems arise in the following manner : (1) Will the way in which payment is raised and the way in which it is spent take place without producing disequilibrium in the balance of payments ? The country making the transfer will wish to create an offsetting export surplus ; the receiving country may spend part of the transfer on imports, but will the extra import bill equal the export surplus of other country ? (2) If the post-transfer balance of payments is no longer in equilibrium, how will the adjustment mechanism work ? In what direction the terms of trade will move in order to restore equilibrium ? The classical economists argued that the transferring country suffered a primary burden in having to raise the transfer (e.g., by increasing taxes) ; it might also suffer a secondary burden of the terms of trade turned against it as a result of the transfer. The classical view, in fact, was that the terms of trade would turn against the transferring country. However, modern theoretical analysis shows that, under certain circumstances, the terms of trade can move in either direction.

Suppose that country X makes a transfer payment to country Y. In order to make the transfer, X might reduce domestic incomes and expenditure, and as a result spending on imports will fall. Conversely Y will now have a bigger income and will therefore increase its spendings on imports. Both these effects of the transfer will improve X's balance of payments. However, whether or not improvement in the balance of payment is sufficient to offset the deterioration due to the capital transfer will depend on the size of the marginal propensities to import of the two countries. If the sum of the two marginal propensities of the two countries is equal to unity, the balance of payments will balance after the transfer has been made. If the sum is greater than unity, then X will have a net export surplus and so, to restore equilibrium, the terms of trade will move in favour of the transferring country. Similarly if the sum is less than unity, X will have a net import surplus, and so, to restore equilibrium, the terms of trade will move against country X.

Thus for the classical view to hold, the sum of elasticities would have to be less than unity ; a condition which may not be fulfilled in practice. However, the transfer may be financed out of savings with the result that aggregate expenditure may not fall by as much as the size of the transfer. On the other side, the receiving country may simply add to its savings (at the individual or central bank level) and therefore not increase its expenditure on imports. Also transfer may have multiple effects on

income and therefore on the balance of payments. Thus of the transfer comes from and goes into savings, then exports and imports will be unaffected and country making the transfer will finish up with a deficit in its balance of payments.

To eliminate the deficit, the terms of trade will have to change against the country making the transfer. This will take place if deflation follows or devaluation takes place. Johnson has developed a model showing that any outcome (of the transfer on savings and spending directly and induced changes in saving and spending through the multiplier) so far as the terms of trade are concerned is possible and there is no reason *apriori* to expect them to move in one direction rather than another. The outcome will depend on the net effects of income changes in the two countries, the relative propensities to spend on domestic and import goods and the elasticity of the supply of the two categories of goods in the two countries. Johnson's analysis is in term of two countries operating on fixed exchange rates with the transfer being "affected" via income and price adjustments.

Kemp has studied the problem under flexible exchange rates ; i.e., where the balance of payments is always in equilibrium and changes in the terms of trade are represented by changes in exchange rates between the two currencies. Under such conditions, Kemp analyses the effect of raising the transfer in various ways (by means of borrowings from the Central Bank, by raising income-tax or by imposing a tax on imports) and also looks at how the way in which the receiving country distributes the transfer, affects the outcome, so far as the rate of exchange (i.e. terms of trade) is concerned. Again depending on the size of the relevant propensities and income changes, the rate of exchange may either depreciate (i.e. a deterioration in the terms of trade) or appreciate (i.e. an improvement in the terms of trade).

To discover the probable movement of the term of trade in any specific instance, one would have to analyse empirically the determinants of the system. This has been (Kindleberger) attempted but the results are inconclusive ; although it might be reasonable to argue that capital transfers from advanced industrialised countries to small under-developed countries are likely to cause shifts in the terms of trade in favour of the capital importing country. This would be so because the increases in the demand for advanced countries goods will be relatively small and supply elasticities of their exports will be fairly high. Also the supply elasticities of under-developed countries may well be low. In spite of the general hypothesis, one feels that generalisation regarding the effects of transfer on the terms of trade are apt to be highly misleading. One must simply take each case on its merits and analyse the forces operating these. The same criticism can be made of the analysis of historical movements in the terms of trade, whatever their cause.

Suggested Readings

1. C.P. Kindleberger : International Economics.

INTERNATIONAL CAPITAL MOVEMENTS

Q. "International capital movements can take place in different ways." Explain.

Or

Examine the factors which lead to short-term capital movements.

Or

Explain how long-term capital movements are caused.

Or

Examine the problem of capital movements in the context of developing countries.

Or

Discuss how the interest of developed and developing countries clash on the need and form of foreign borrowing.

Ans. International capital movements can take place in many different ways. Capital can move from a country if residents of that country, or its government, choose to acquire claims against foreigners or foreign government (such as bank deposits abroad, foreign bills, bonds or shares) or if they acquire real assets abroad (as when a firm builds a branch factory in another country). Similar capital can move into a country if these operations take place in the opposite direction.

Short-term capital movements can be distinguished from long term capital movement in two ways : (a) whether the transaction involves short term claims (with duration to maturity of upto a year) such as bank deposits and bills, whether it involves long-term claim and fixed assets ; (2) whether the capital movement is durable or not ; if it is likely to be reversed quite quickly it is a short-term movement ; if not it is a long-term movement. There may be overlapping in that temporary shifts of capital may use long-term assets (such as purchases of stocks and shares) and relatively permanent movements may use very liquid assets (such as bank deposits).

Short-term international capital transactions involve the movement of

stock of capital, while long-term transactions involve the flow of news of capital from one country to another. Total volume of short-term transactions is fairly large in relation to annual accruals to the total international short-term capital while the total transactions involving long-term capital are more closely related to the annual accruals to the total amount of long term capital in existence.

Factors causing short-term movements.

(1) Changes in interest rates lead to short-term capital movements. Assuming exchange rates to be stable, if short-term interest rates rise in one country, then it is expensive to borrow from that country and advantageous to lend to it. If long-term interest rates rise in that country, the bonds of this country may be bought for speculative reasons, in the expectation that interest rates would fall shortly. If, however, exchange rate changes or falls in the same country, the advantage of lending to it is cancelled out and probably no movement of short-term capital emerges.

The effects of interest rates on short-term capital movement were significant when exchange rate changes were few. However after thirties, the expectations of exchange rates changes have multiplied, consequently the effects of short-term interest rate changes cannot be predicted with confidence. In this way before 1914 changes in short-term interest could attract capital and foreign payment position could become comfortable. Now this no longer happens. Only short-term capital movements by public authorities (Central Bank) which are deliberately designed to have a stabilising effect on the balance of payments are successful.

Other factors like fear of political changes and war affect short-term capital movements. However, high interest rates may be and however, stable exchange rates, short-term capital is likely to leave a country subject to political disturbances or which is expected to impose restrictions on foreign payments. In disturbed conditions, fear leads to swift movements of short term capital around the countries, so much so that the problem of hot money arises.

Factors leading to Long-term Capital Movements.

Movements of private long-term capital are affected by similar factors. Expectation of exchange rate changes, either in the near or in the distant future, affect willingness to acquire claims or take on liabilities expressed in foreign countries. Similarly, interest rate changes affect movements. If interest rate rises in one country, foreigners will tend to lend more to that country and residents will tend to lend less abroad. This rise in interest rate should not lead to expectation of further rises because in that case movement becomes indefinite and speculative. If this does not happen, then, rise in long-term interest rate attracts foreign private long term capital to a country.

There are likely to be continuing effects. A high level of interest rates in one country is more likely to attract a large proportion of the new flow of savings into the long-term capital markets of that country. In this way

continual inflow of long-term capital occurs as a result of high interest rates. Profits earned in the home country also influence the movements of long-term capital. If these are large and if interest rates are high, continual inflow of long-term capital occurs.

Capital Movements and Income Levels.

Foreign loan may lead to additional expenditure in the borrowing country. It leads to a higher level of income and expenditure in that country. If the resources are fully utilised no additional expenditure results, and no higher level of income occurs. Usually the borrowing country can avoid a reduction in its level of income by maintaining the real expenditure through imports. In the other situation foreign borrowing enables it to increase its level of expenditure and thereby to achieve a higher level of income.

In the lending country an outflow of capital occurs as a result of lending. This leads to balance of trade surplus which leads to multiplier expansion of income. The assumption is that full employment has not been achieved. In this way justification can be provided for lending at low interest rates.

Indirect effects on the Balance of Payments.

Capital movements in the form of long-term loans affect levels of income indirectly also. Two situations emerge. Firstly, the loan may be used to invest in the home-produced capital. Secondly, it may be used to finance imports. Different results are likely to follow in each case.

When loan is used to spend in investment in home produced capital, a multiplier expansion of income and expenditure occurs in the borrowing country. A higher level of income emerges and balance of trade usually moves in favour of the borrowing country.

In the other situation, foreign loans may be used to finance imports. This might lead to adverse balance of trade for the recipient country. However, this may not be the final picture. Increased imports lead to expansion of income in the lending country which might signify increased levels of income for the borrowing country. In this way level of income may be increased in both countries. The increase is evident in the borrowing country because it imports larger amount of goods than it could by virtue of its balance of payments position. In this the borrowing country experiences net improvement in the balance of payments and a deterioration in the balance of trade.

THE PROBLEM OF CAPITAL MOVEMENTS IN THE DEVELOPING COUNTRIES

Needs of Capital Recipient Countries.

Developing countries are facing the acute problem of financing their economic growth. In order to enlarge the volume of output available to

its population and for exports, a developing country has to expand its productive capacity. This calls for immense resources for capital formation and for the adjustment of the level of consumption accordingly. To increase the rate of investment in an economy with a relatively low level of industrialisation, requires a certain level of savings and also a certain volume of foreign exchange for importing the machines and the necessary raw materials. It also requires a certain level of technology to complement the available capital. Serious obstacles will have to be overcome on all these counts by the developing countries.

As for increasing the level of domestic savings, the vicious circle of poverty has to be broken. With the lower level of personal incomes, greater proportion of it goes for essentials. And it is very difficult to squeeze consumption in order to release resources for capital formation. It requires radical institutional changes to mobilize the domestic savings and deploy them in sectors in which they can be profitably used for purposes of development.

The role of external financing is chiefly one of expanding the capital volume, so as to supplement to some extent the resources made available domestically. But the forms in which external finances are provided have become increasingly diverse and this presents manifold complications not only for the recipient countries but also for the donor countries. The traditional channels for the international movement of capital, direct private business investment and floatation of bonds by the public authorities, have proved not only inadequate for the transfer of resources but have also posed certain additional questions.

The capital by its very nature is a scarce factor even in the most affluent societies and they have too many factors before transferring resources to the developing countries. And these countries try to look at the question of minimizing the ratio of real costs to the potential benefits. Besides, politics weighs heavy in every such transfer even if it is advisable on economic grounds. This has involved the exercise of stricter control of the assets transferred. This type of wholesale tying in its various forms has flung out problems of utilisation for the recipient countries in the matter of trying to co-ordinate external finances and domestic savings within the framework of their development plans.

Although in recent years the terms of these transfers have tended to ease, and there are not too many political strings attached, yet the interest charges and the repayment of principal have created difficult conditions for the developing countries. As a result there has been a speedy increase in the external debt of the developing countries and servicing also consumes big slice of foreign currency. And with the sluggish rise in the exports of developing countries this burden of debt service has gone still higher. In order to ease out the situation, mass transfer of resources from the developed to the developing would be required. But on the contrary there has been a decline in the transfer of resources in the shape of new loans, grants and investments in recent years. As a result the contribution of external financing to the developmental effort of developing countries,

has declined considerably. And the developing countries, most of them, have not been able to mobilize the amount of capital formation required to work up the annual rate of growth to 5 per cent per annum.

The situation would, therefore, call for both an adequate rise in the rate of domestic savings and a considerable expansion in the capacity of developing countries to import. The latter thus depend on the amount of foreign exchange reserves made available through exports, grants, loans etc.

But the fluctuation of external finances depends not only on its magnitude but also on its forms, particularly on its liquidity and the extent to which it helps to meet various strategic requirements. The developed countries, though not all, at the UNCTAD II, have reluctantly reaffirmed their assurance to part with one percent of their G. N. P. to the developing countries, for the bridging of any gap. But it will not by itself help to ensure a higher sustainable growth rate for the countries for whom trade gap is the only bottleneck inhibiting the rate of growth. It would depend on the nature and terms on which such external finances are provided and also on bringing complete socio-cultural and institutional changes which may ensure a rapid rise in productivity. In this context, it is obvious that the importance of proper utilisation of these resources can hardly be over-emphasized.

Problems of Capital exporting Countries.

The developed countries have their own growing requirements of investment and for them, to spare, something out of their resources which might be needed at home, would pose a problem of immense importance. These countries have magnified the needs of capital in the domestic market as a result of extra-ordinary acceleration in the rate of technological change that has come to characterise their development. The developing countries in competition with the developed ones cannot attract the natural flow of capital. Even the monetary, fiscal and direct measures like the 'tax holidays' resorted to by the developing countries have not attracted the potential investors from abroad. Nearly the whole of whatever little private foreign investment comes to the under-developed countries, goes to extractive industries, concerned with the exploitation of localized natural resources. The countries deficient in natural resources and with a limited size of the market are not in a position to attract enough capital item of this type. Foreign capital instead of developing the domestic economies of low income countries has served to harden and strengthen the system under which these countries specialised in the production of raw materials and foodstuffs for export. Foreign investment according to this view, tended to promote a pattern of specialisation based on the state scheme of comparative advantage in international trade. Even if this concentration in extractive export industries did not necessarily mean exploitation for foreign profit or still less exploitation in any popular political sense, it meant all the same that foreign investment served primarily the interests of individual creditor countries and that the

economic growth resulting from it was inevitably somewhat unbalanced in character.

As the private foreign investment cannot meet with all the requirements of the recipient under-developed countries, reliance is also placed on the public foreign investment. Public foreign investment has the advantage of being used in accordance with the overall programme of economic development and is thus directly linked with the economic growth of the debtor country. Public foreign investment has an advantage over the private foreign investment in the sense, that it is not open to the usual objection, that such investment serves the needs of the lending country only and adds to the unbalanced character of the economy of the developing country. If the loans are raised through international agencies, the borrowing country can also free itself from the political interference that the creditor country may impose in the matter of formulation of domestic policies of the debtor country. Besides, there are certain risky undertakings whose object is greater social return. Such risks cannot be undertaken by private enterprise. In that event, public authorities alone can do the needful with the help of foreign public investment.

The philosophy behind public loans could be explained in the following manner :

Public loans represent the resources accumulated out of the contributions of the citizens of the creditor countries and these resources lent to the poor countries could be usefully employed in expanding the economies of advanced countries. So if the advanced countries part with some of their resources they make it subject to some ties. It has been increasingly felt that public loans or aid made available to the developing countries have not been spent properly. Since these come from the pockets of the tax-payers of the developed countries, there is every justification of their demanding use of the funds that finance the economic development in developing countries, in the manner which according to them should be right. Thus public foreign finance is also made to serve the interests of creditor countries. Advanced countries deem it essential that such public foreign investment serves the interests of their own people. There is scarcity of resources throughout the world, and they argue that the resources lent to the poor countries, could be usefully employed in expanding investments in the creditor countries. As such, public foreign investment, should, of necessity, be expected to give the creditor country the desired rate of return and at the same time save it from the lizards and risks of investing in the poor countries.

Domestic efforts.

Besides, the public foreign investment may result in the slackening of efforts on the domestic front, in that case no real impact will be made to the capital formation in the country. It would almost always be possible

to some extent to substitute foreign funds for domestic savings so that the country's consumption is increased and little or no addition is made to the rate of accumulation. This can happen even if each foreign loan is earmarked for a specific productive project. If the inflow of capital is accompanied by a relaxation of domestic saving efforts, there may be no change in the total rate of capital formation. The international loans thus will be more effective only if the domestic resources continue to be directed to capital formation in the same ratio as they used to be.

But then there may be bottlenecks in the country's capacity to make the productive use of external loans. The impact of "keeping up with the Joneses" is being greatly felt in less developed countries. The living standards of advanced countries with their close connection with the developing countries, raise the marginal propensity to consume, arising out of the demonstration effect. So it hampers not only the domestic saving efforts but also discourages the proper use of external resources for economic development. Under the development planning, increase in the consumption will also occur steadily because of the increased rate of population growth, trend towards urbanisation and the growing desire on the part of the people to secure higher standards of living. What is required is not to depress the current level of consumption but to arrest the future growth of consumption particularly when it inhibits the accumulation of capital for rapid economic development of the country.

The problem of dealing with the transfer of resources to the developing countries, in the light of pressing domestic needs has presented another difficult problem for the centrally planned economies. The projects, that are made available to be financed by credit upto 15 years, standing have given rise to the problems of integration with the investment plans of both the donor as well as the recipient countries. Besides, these transfer of resources have been concentrated only to a small number of countries. The inflow of capital and further servicing of the debt have exerted a significant effect on the volume and composition of trade between the centrally planned economies and the developing countries in question. The donor country would naturally organize these outflows in closer conformity with domestic planning criteria. Trade prices also affect the real value of outflows to the developing countries. It is not only the question of prices at which various forms of tied transfers and transfers in kind are in fact valued, but the deterioration in terms of trade of the developing countries as a group also dilutes much of the effects of the rising volume of loans and aid. Besides many trade agreements enable the importing country to get the commodity at a price lower than the market price, but then a similar effort is required on the domestic front to mop up the same benefit in the shape of a tax to be used for public investment.

External Grants and Aid

Similar to the inflow of foreign public investment, the impact of external aid on the net contribution to the productive capacity of the country cannot be reflected in easily comprehensible terms. External aid

ostensibly used for increasing the productive capacity may make available the non-aid resources for consumption, and alternatively the external aid received in the form of consumer goods (P.L. 480 imports) may make available the domestic resources for capital formation, though apparently it goes to add to the current consumption capacity of the country. External aid also helps indirectly to increase the growth potential in certain other connected spheres.

But bulk of foreign aid comes in the form of assistance for specific projects. External aid of this type has made useful contribution towards the increase in the productive capacity of agriculture, through its participation in the river valley and other irrigation projects. It has also enhanced the power potential of these countries. External assistance in most of the developing countries has been received in the shape of machinery and equipment from various sources for many of their projects. Productive capacity of the country is enhanced in the matter of technical services.

It may, however, be remembered that donor countries do not give this aid disinterestedly. The donor government or agencies do exercise an influence over the selection of the project and are careful in assessing as to whether the political consequences of granting such aid are in tune with their own political, social and economic objectives. "The essential interest of the West in India is clear. It is reasonable to suggest that in India as elsewhere, it is by the development of a society resistant to the appeal of a totalitarian regime and expecting economic advance in the sense of enjoying a general rise in the living standards. Such a society will generally be one with the following characteristics : the economy is developing ; people had wide access to alternatives both as consumers and as producers ; decision-making is decentralized and widely dispersed, the power of individuals over others is limited; people do not experience violent and discontinuous disintegration of their communities; large number of people own some property. And economic advance if it is to be meaningful, must refer to an increase in the net flow of goods and services desired by the population not simply to an increase in the volume of some categories of physical output, regardless of the individuals comprising the society."¹

Reasons for Aid Tying.

The above analysis alone does not account for aid tying. From the view-point of developed countries, the major reason for aid tying has been to ensure that aid outflow is compensated by export increases and does not present a problem of payments. Almost all the developed countries, more particularly the United States, have considerably increased the scope of aid tying. It has been, as a result of the stampede among the developed countries to enhance their exports on this place, though many of them like Germany are enjoying the most favourable balance of payments situation. The cost of such tying has been enormous for the developing countries. It eliminates not only the scope of free bargaining

1. P.T. Bauer, *Indian Economic Policy and Development* (London, 1961), pp. 122-23.

in the open market but also restricts the choice to only a particular type of product that may have to go in for.

Under the present gloomy political atmosphere and depressing state of balance of payments of the major donor countries, to press for untying of aid may even result in less aid. UNCTAD-II has worked out possible solutions and it appears to have prevented the situation from deteriorating further. Any steps that are taken towards the untying of aid should only work constructively to alleviate the effects of tying.

Substantial amount of aid which an individual country seems to get depends not only on economic considerations but on their political links with the individual donor country. But no solitary step can be taken by a single donor country to soften the terms and conditions of aid, there ought to be a co-ordinated effort on the part of all the developed countries, so that it may serve the interests of developing countries, to the disadvantage of none of the developed ones. One donor will find it hard to liberalize the terms if others are much more stringent and in effect get their services at his expense.

There may be difficulties for the developed countries as well in parting with genuine aid. That is why even at the UNCTAD II, many of the developed countries have shown their clear reluctance to soften the terms and conditions of aid. Most of them do not agree that all the developing countries should receive International Development Association terms, as has been proposed by the Algiers Charter. Their argument was that only a few countries needed the softest terms while others could finance their development through market loans and commercial credit. But as a matter of fact such groupings will not only involve political considerations alone in matter of distributing grants and aid. Besides, it also presents a too optimistic picture of developing countries. 1700 million people of the peripheral world were committed to paying 14,230 million dollars to the developed countries as their debt by 1975. And even if the exports of these countries rose at 4 percent per annum, substantial portion of increased export earnings will be eaten up by debt repayment. Thus the developing countries have to pay a very high price for the loans they borrow.

Although much of the aid will continue to come only under some sort of tying, and there is not the conducive political climate and comfortable balance of payments situation for such an aid to flow freely, yet the developing countries requirements for such an aid seem to be too essential for their development programmes. The popular demand that each donor country should set aside one per cent of its national income for aid to the developing countries, it is not acceded to, even in principle, by all the Western developed countries and those who have accepted may find it difficult to implement it in details. "Since the prospects of getting such commitments immediately are extremely poor, there should be an attempt at the very least to get easy commitments to ensure that no donor country reduces its over all aid flows below its best level in the last—"

decade, measured in real terms, since aid can also be watered down by converting grants into loans and by making loans on stiffer terms. Definite commitment by the rich countries must be sought in this area as well. Since the repayments on past debts have begun to mount in several less developed countries until they even exceed the gross inflow of fresh aid in a few countries, convention and commitments also need to be established to ensure that the aid outflow which is to be agreed upon as a result of contractual obligations should be defined in not rather than gross terms.¹

Since it is not possible to have aid without strings, the creditor countries must observe certain rules of the game so that the aid which comes to the developing countries should be fruitfully utilized for their economic development. But, unfortunately, the present terms and conditions of aid tend to serve the interest of the developed countries more than those of the developing ones. This is one of the reasons why these aids and loans received by the developing countries are considered as nothing short of necessary evil. And in their opinion there is not an end to exploitation of the developing countries by the developed ones. It has only changed shape as compared to the old colonial days.

If the developed countries are really interested in providing aid to the peripheral countries, they must conform to certain simple and important rules, which would minimize the costs which are directly related to the aid strings. They should avoid the joint tying at the source and commodity specifications, (which encourages the monopolistic exploitation by the donor country), provide competitive tendering on tied projects and greater price vigilance in the donor countries. Currently the donor countries are not adhering to any of these norms and the aid which comes to the developing countries seemingly sufficient, falls in real value and appears most uneconomical when the exorbitant interest charges are also taken into consideration.

The question of supplementary financing also came in for a good deal of discussion at the UNCTAD II. But the scope of supplementary financing has also to be properly specified. There is a good deal of relevance in providing such supplementary financing to the less developed countries whose developmental plans were jeopardised by shortfalls in the projected export earnings. This scheme should make sufficient headway, but at the same time, it should not be treated as a substitute but as real supplementary financing which will not be offset by the corresponding reduction in aid commitments by the donor countries.

Obligations of the Developing Countries.

No doubt the developed countries should make their honest attempt in providing genuine aid on much softer terms, but the responsibility of utilising this aid properly, falls entirely on the developing countries themselves. They are expected to make a selection of their projects properly

1. J. Bhagwati, Hindustan Times, UNCTAD-II supplement, Feb. 1, 1968.

and shoulder the financial burdens which the recipient country deems fit to bear. However, there has not been enough aid but whatever little is forth coming, the developing countries must show the financial prudence in accepting it so as to avoid the embarrassingly threatening situations.

UNCTAD-II seemingly appeared to have resolved many of these issues. There was general agreement that an intergovernmental group should be set up to study the problem of supplementary financing. Loan terms were considered to be hard and a system of harmonization had to be worked out for the free flow of aid by different donors. It was agreed that the indebtedness of the developing countries was considerably reducing their export earnings as a result of the outflow of funds to pay off loans. But nothing definite in this regard has been laid down as some of the western countries attended the conference with the motive of 'conceding the least that is consistent with their general professions.' Tying of aid as such will not go, though some countries like France and Britains slowed their inclination in this direction. But they are not prepared to be the torchbearers in this respect and consequently suffer the loss. The loss to the recipient country varies to the degree with which choice is constrained, import priority attaching to the resources actually obtained, and the competition of their prices in the world market. Tying is also not likely to go because of the pressure on the balance of payments of developed countries which want to restrain the outflow of capital and adopt other measures to project their international liquidity. It is the liquidity difficulties with some of the developed countries that have resulted in the gradual slowing down of the flow of resources to the developing countries. This calls for modifications in the world monetary system, so that liquidity creation can be better controlled in the interests of international trade in general and the transfer of resources to the developing countries in particular.

Q. Describe the manner in which exchange rate changes influence capital movements.

Or

Examine the large scale capital movements that have been occurring in the developed world since 1960. How far can these be related to exchange rate changes?

Ans. Capital Flows, Exchange Rates and Controls.

It is very difficult to establish the effect of exchange rate on capital movements. So far the analysis has concentrated on current account. Yet, exchange rate changes have influenced capital account more dramatically. The Israeli devaluation of 1962 restored confidence in the worth of Israeli pound at its depreciated rate and induced a large reflux of capital into Israel. A large part of this was spent on durable goods and this spoiled an otherwise successful devaluation. The effect can hardly be explained because low and middle income groups spent the money while their propensity to save theoretically is high.

More commonly devaluation stimulates a return of capital for working balances and for financial investment. This can help rebuild official reserves. Britain experienced it in 1931 and 1949. On both occasions, a sterling devaluation of around 30 percent put the foreign exchange value of the pound on a demonstrably undervalued basis, and contributed for a doubling of reserves within two years. Thus earlier depreciation in sterling stimulated rather than deterred further overseas accumulation of sterling.

Exchange rates have a more uncertain effect on flows of long-term capital. If dollars become cheaper in terms of marks, this will probably stimulate German purchases of American securities and American factories as well as of American cars and American ball-point pens. Thus a revival in investments occurs once the exchange rates are altered to a level that is considered appropriate. Thus it is the level of existing exchange rate in relation to its expected future level that is the main relevant influence on capital movements, rather than the level of exchange rate itself. Devaluation will also normally make it more profitable for foreign manufacturers to supply the market of the devaluing country from local manufacture rather than from exports; this will induce an increase in inward investment at the expense of imports. There should be a parallel increase in exports at the expense of outward investments. This will reflect the relative cheapening in the cost of manufacture in the devaluing country—the cheapening in its costs in terms of foreign currency. The extent of this influence will depend on the effect of higher domestic prices for imports and import substitutes in curbing domestic demand for these products in the devaluing country, and on the elasticity of foreign demand for its exports.

Expectations of an appreciations of European currencies against the dollar influenced to some extent the large and persistent outflow of capital from the United States to Europe in the 1960's. Other influences could be a rapid growth of European economies, the formation of capital market, increased security, weakness of the dollar and the desire to get into non-dollar assets. Availability of finance could also be an important factor. American corporation received huge cash flows and these helped them to penetrate the overseas markets. Besides the desire for prestige, for a world-wide spread could have played some part.

By the 1960's these influences were inducing large movements of capital between developed countries. The existing payments system could hardly cope with these. As a result, this period saw a gradual retreat from convertibility on capital account by the imposition of direct controls, interest surcharges and exchange premiums which are in effect attempts to establish a different exchange rate on capital and current account. In themselves, such differential exchange rates may theoretically have a bigger effect on capital movement than a general exchange adjustment, by avoiding the parallel effect on future investment income; a special capital tax makes the outlay dearer without putting an equivalent premium as the future return. Against this, controls and differential interest rates are in practice of doubtful efficiency. Money has a strong natural

tendency to find its own level and controls may even have perverse effects in making the forbidden appear the more desirable, reinforcing the universality syndrome.¹

Summary of Roy Harrod's Articles, "Capital Movements and Growth."

- (i) Shortage of capital disposal is only one among many factors, limiting growth in the developing countries.
- (ii) Any attempt to increase capital disposal at a much greater rate than the co-operant factors can achieve would be subject to the law of diminishing returns (dynamized version), and likely to contribute little to the progress of developing countries, while imposing an unjustified burden on mature countries.
- (iii) It would be desirable to make capital disposal available to developing countries consistent with the maximum possible rate of growth of non-capital factors.
- (iv) The law of comparative costs should determine the direction of development. Exportable goods are preferred to import competing goods.
- (v) Borrowing from abroad should normally be regarded as imposing a net long run burden on a country's balance of payments. It cannot be obviated by increasing borrowings each year.
- (vi) A developing country with poor capital equipment cannot achieve the potential development unless foreign capital is borrowed. The aim should be to make the developing country self-sufficient on capital account.
- (vii) It is assumed that twenty years period would be sufficient for such an end to be realized. Some amount of rising consumption may be allowed to elicit the co-operation of non-capital factors in the country.
- (viii) The rise in consumption should not exceed $\frac{1}{2}$ per cent, otherwise independence from foreign borrowing is hardly possible. Reduction of foreign service charges may be desirable and may act in a complementary way.
- (ix) Always provided that the growth potential of non-capital factors domestically available is sufficient, a larger supply of foreign capital at the outset and a more intensive crash programme will have more successful result than a slower plan and require a cumulative amount of foreign borrowing at the peak.
- (x) Difficulties are involved in translating the lessons derived from macro-economic table to micro-economic scales e.g. to particular capital projects.
- (xi) The problem of preventing an excess distribution of income remains. Taxation, restrictions on consumable imports and consumable exports and so on may be followed.

1. Fred Hirsch, *Money International*, (Hasmondsworth, Penguin Book Ltd., 1969, p. 449).

- (xii) Voluntary savings may not be as high as required. So sufficient rate of company savings should be compulsorily secured. A levy should be imposed on foreign-owned capital so that some part of retained profit is made available for domestic expansion without increasing foreign indebtedness.

Gunnar Myrdal on Capital Movements from the Point of view of Developing Countries.

- (i) There is a widening gap between the import-needs and the actual export returns in the underdeveloped world.
- (ii) Exports difficulties have been persistent, import need can be restricted only at the expense of development, financial aid from developed countries constitutes one type of solution. For many years, such aid has been stagnating and in real terms, decreasing.
- (iii) Aid consists of loans which implies later outflows of interest and amortisation the interest rate has been rising and the average maturity of new loans and the grace period have been shortened.
- (iv) Rising debt burdens for developed countries have been resulting. It has been calculated that the accumulative debt of these countries have increased from \$ 10 billion in 1950 to \$ 40 billion in 1965 and that they are continuing to increase and will in future years also.
- (v) Annual payments of interest and amortisation over the period 1950-65 have increased from \$0.8 billion to \$3.6 billion. The ratio of debt service payments to export returns rose from less than 4 per cent in the middle 1950's to 9 per cent in 1965. If the present trend continues, all the gross inflows of capital will be swallowed up by the outflows, including the debt service, sometimes in the early 1970's. Engens Black, President of the World Bank, saw danger that "the machinery of economic development could be overloaded with foreign debt until it sputtered to a halt amid half-built projects and mountains of discarded plans." The situation has deteriorated further. The remedy could be more public grants and easier credit condition. However opposite has happened.¹

Suggested Readings

- | | | |
|----------------------------------|---|---|
| 1. C.P. Kindleberger | : | International Short-term Capital Movements. |
| 2. R.G. Hawtrey | : | Currency and Credit |
| 3. American Economic Association | : | Readings in International Economics. |
| 4. Fred Hirsch | : | Money International. |
| 5. Gunner Myrdal | : | Challange of World Poverty. |
| 6. S. C. Nandwani | : | Trade Dilemma of Developing countries. |

1. Gunnar Myrdal, *The Challenge of World Poverty* (Hasmondsworth, Penguin Books Ltd. 1970, pp. 285-86)

METHODS OF PROTECTION

Q. Examine the case for tariff protection in an underdeveloped country. In what ways can such protection be practised ?

Or

Discuss the effects of tariffs on income distribution.

Or

Examine the view that developing countries like India should receive special exemptions from any international rules limiting national commercial policies, because such countries develop large trade deficits in the initial stages of development.

Or

Analyse the objectives and the price effects of the quota system as a measure of trade policy.

Or

"Import quotas are much like tariffs." Discuss.

Or

What do you mean by "protective tariffs" "Revenue tariffs" and "Discriminatory tariffs." Are non-discriminatory tariffs better than discriminatory ones.

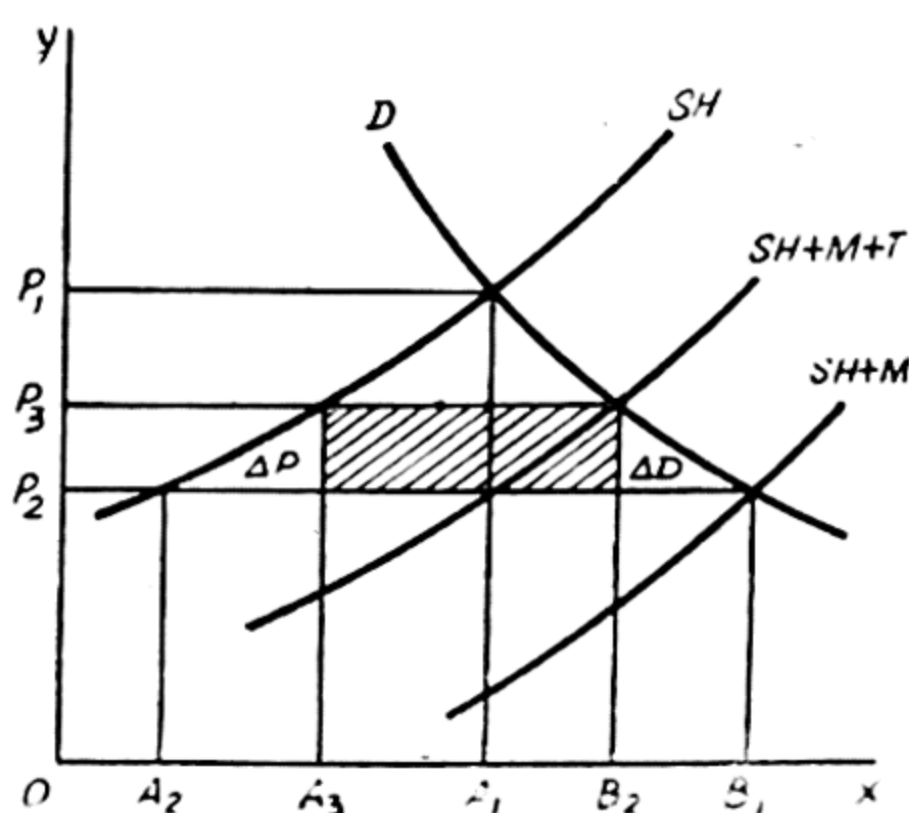
Or

Analyse the rational of bilateral trade and payment agreements. Is it possible to reconcile such agreement with the articles of agreement of the IMF ?

Ans. TARIFFS

The tariff is one of the most common interferences with the working of the free market system. It, however, does not imply the complete abrogation of the price system. It can hardly prevent a country from selling its products, if it succeeds in producing them at sufficiently low costs. In this respect it differs from other quantitative controls. The object of the latter is to restrict imports irrespective of cost considerations. A tariff can be specific or advalorem. A specific duty is based upon the quantity of a product imported and is expressed as so much duty for per lb. or per some other quantity unit. An advalorem duty is based upon value. It is expressed as so much percentage of the value of a given import. The tariffs of most of the countries are generally advalorem ones. Although a large number of specific rates still exist especially on food products. The protective effect of a specific duty becomes eroded with inflation. While from this point of view an advalorem rate remains constant.

We can assess the effect of the tariff by looking up at the consequences of a duty upon a particular product (partial equilibrium approach) or examining the effect of a general duty on all imports of a country (general equilibrium approach). Let us analyse the effects of a duty on a particular product. Let us suppose that the U.K. produces cars and the figure shows the D curve and the home supply curve Fig. SH. In the absence of imports, the equilibrium price is P_1 . If imports are permitted, demand curve will remain constant but the supply curve will be a changed one i.e. $SH+M$. It shows the domestic supply plus imports. New price is P_2 . At this price, domestic supply is OA_2 and imports A_2B_1 . The total quantity consumed is OB_1 . Now the country imposes an import duty. The new combined import and home supply curve will be $(SH+M+T)$, the new price being P_3 . This new price will be higher than the pre-duty price, although not so high as P_1 where there were no imports at all. The extent of the price increase will depend of course on the elasticities of demand and supply. The less elastic the demand in the U.K., the greater is the price increase following the imposition of the duty. The greater the foreign elasticity of supply the smaller the price increase. If the foreign suppliers react to the tariff by selling less in the U.K., they would maintain their place in the U.K. market. The whole burden of the duty will be born by the supplying country. The primary effect of the tariff is a price one. But the price change also brings off other changes. In the figure the price rise from OP_2 to OP_3 causes domestic output to increase from OA_2 to OA_3 and imports to fall from A_2B_1 to A_3B_2 . Total consumption falls from OB_1 to OB_2 . There is the revenue effect since the government will be collecting duty equivalent to the shaded area (duty multiplied by the number of units imported). Revenue effect of a tariff is particularly important in some of the developing countries.

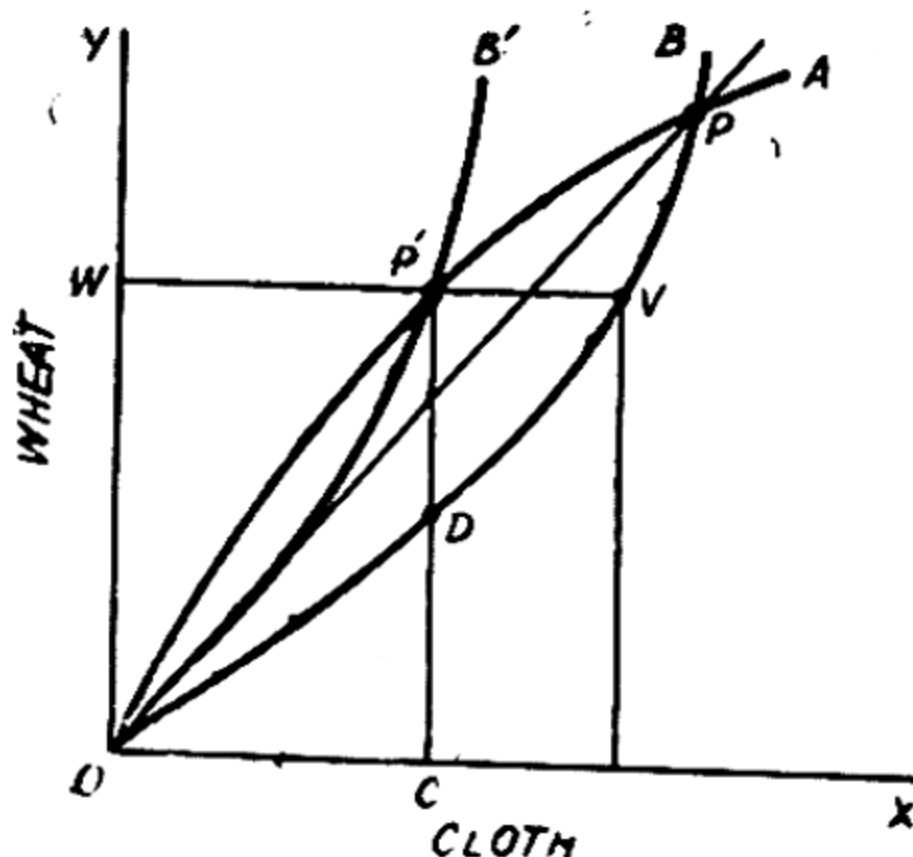


There is also a redistributive effect since domestic producers of protected goods gain at the expense of those who consume the imported product. In the above figure the protective effect of the tariff is shown by

the area of $\triangle P$ while the consumption effect is shown by $\triangle D$. The area of the $\triangle P$ depends upon the height of the tariff and the increase in domestic output, the latter depending upon the shape of the domestic supply curve. The area of the $\triangle D$, which represents the loss to the consumer caused by the tariff, depends upon the extent to which import supplies are reduced ($OB_1 - OB_2$) and the rise in the prices following the imposition of duty ($OP_3 - OP_2$). It thus gives a measure of consumer's loss following the imposition of duty. Accordingly, in welfare terms, we may measure the economic loss from the tariff by adding together area P and D , the former measuring the production loss and latter a consumption loss.

Terms of Trade effect.

The static argument in favour of the tariffs at the natural level is that under the appropriate circumstances a tariff will enable the country to obtain its imports cheaper. In effect, the foreigner pays the duty or some considerable part of it. This can be better demonstrated with the help of offer curves. The figure shows a pair of offer curves of Britain and the United States OB and OA respectively which intersect at P . This gives a price OP between the two commodities, wheat and cloth. A

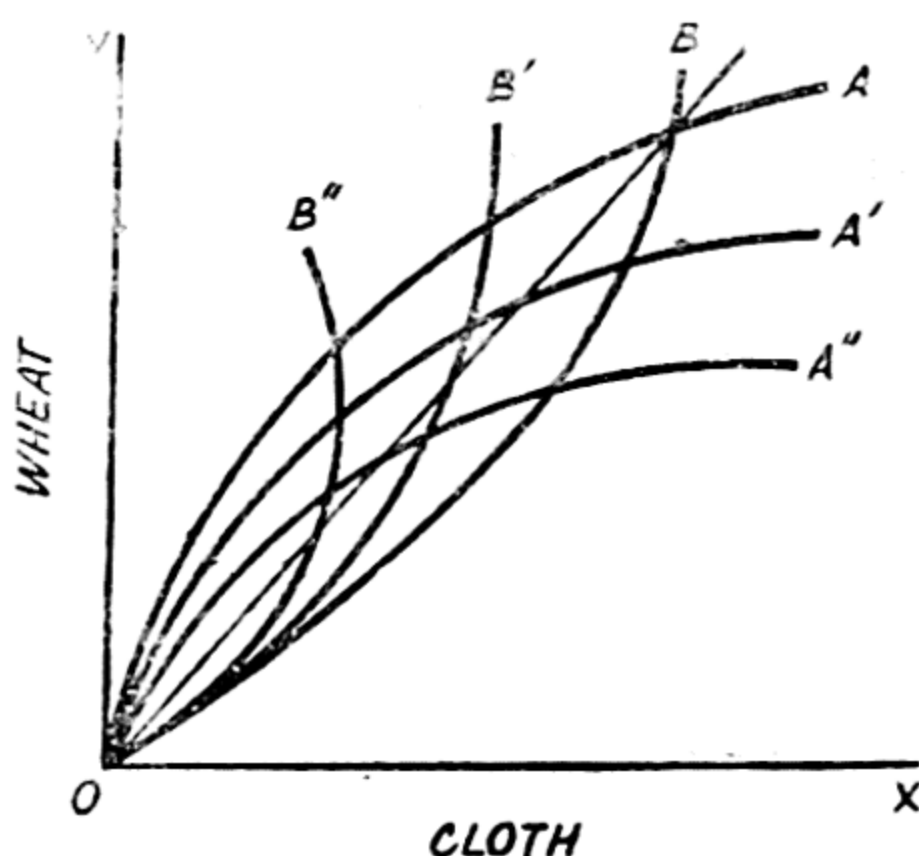


tariff imposed by Britain on wheat from the United States may be represented by a new offer curve, OB' . The tariff-distorted offer curve, OB' , may represent either an import tax on wheat or an export tax on cloth. As an export tax, Britain is now prepared to offer less cloth for a given amount of wheat, collecting the export tax in cloth. For OW of wheat, for example, it used to offer WV of cloth but now offers only WP' , collecting $P'V$ in taxes. Or it used to be prepared to offer OC of cloth for DC of wheat, whereas now it requires $P'C$ in wheat, collecting $P'D$ as tariff.

The shift of the offer curve from B to B' changes the terms of the trade from OP to OP' . This is an improvement for Britain.

The improvement in the terms of trade may or may not make the country as a whole better off. In retailing, profit per item can be very high, but if sales fall way off, total profit is less than of the rate of profit had been more modest. Similarly, there is an optimum tariff at which any further gain from the improvement in the terms of trade would be more than offset by the related decline in volume. This optimum represents that tariff which cuts the opposing offer curve at the point where it is tangent to the levying country's highest trade indifference curve.

But the retaliatory action is more common in tariff. The United States can retaliate if Britain decides to improve its terms of trade by imposing a tariff. In the absence of such retaliation, the British can gain. But if both the parties retaliate, they almost certainly lose. The figure shows such a case in which tariffs imposed by Britain and the United States in retaliatory sequence, B, B', B'' , and, A, A', A'' , and so on, leave the terms of trade unchanged at the end but greatly reduce the volume of trade. Each country would have been willing to buy and sell much more at these terms of trade if the price relationships in



(Tariff to improve the terms of Trade-Retaliation)

domestic trade were the same. Both countries stand to lose in the reciprocal imposition of the tariff duties. The reciprocal removal of tariff, on the other hand, enables the countries to gain. This can provide an explanation of the reciprocal nature of the Trade Agreements Programmes in the United States and the GATT.

The Income Effect.

Tariffs affect income and employment. Imposition of tariff increases income and reduces unemployment. A reduction or removal of tariffs reduces incomes and increases unemployment. The argument in brief is that tariff raises the import prices and consequently shifts the import schedule downwards. Consumers shift their purchases to home produced import competing goods. This will increase income by an amount which

is a multiple of the decline in the imports at the starting level of income.

The gain in employment brought about by the increase in natural income in the tariff imposing country, however, is achieved at the expense of a decline in natural income and employment abroad where exports are cut off. Since income is adversely affected abroad and since the rest of the world is likely to retaliate in tariffs, it is hardly possible for the country concerned to increase employment by raising tariffs. Firstly, because foreign recussions are likely to be substantial and consequently foreign retaliation is also a distinct possibility.

Thus the shift in tariffs to promote an increase in national income amounts to a better-thy-neighbour policy. However, the removal of tariff barriers is an ideal measure to restrain inflation particularly when rising exports contribute significantly to the inflationary pressures.

The Balance of Payment Effect.

There has been some confusion about the effects of tariffs on the balance of trade. The popular opinion was that they of course improved it. Tariffs reduced imports but did not affect exports. Conversely a reduction in tariffs worsened the balance of trade. That is one reason of the slogan "Trade not Aid" calling for a reduction in the tariff walls created by the developed countries for the goods of the developing countries.

More sophisticated reasoning lead to a modification of this view. The tariff diverted spending from foreign goods to domestic goods. This resulted in a higher level of income at home. At the same time import prices were increased and average propensity to import out of a given unit was reduced. Increased level of income meant that more rupees could be spent on the increased price of the imports. Thus the balance of trade was left unchanged.

The interaction of the effects.

All the effects of a tariff cannot operate with equal intensity at the same time. They are related to one another in many ways. The more protective and the consumption effects cut down imports, less the revenue gained from a tariff. At the limit, of course, the tariff may be so prohibitive that it yields no revenue. The more substantially the terms of trade change and lower prices abroad rather than raise them at home, less the protective and the redistributive effects. If the revenue effect is large, the impact on the balance of payment is determined by the terms of trade.

Conclusion

Tariffs stimulate production, raise revenue, redistribute income within and between the countries, expands employment and alter the balance of payments. But others and more equitable devices available for these purposes do not have the undesirable effects of distorting the allocation of resources and limiting consumption. Subsidies do equally well viz. a viz. tariffs. They stimulate output without restricting consumption. Direct taxes and transfers are superior to

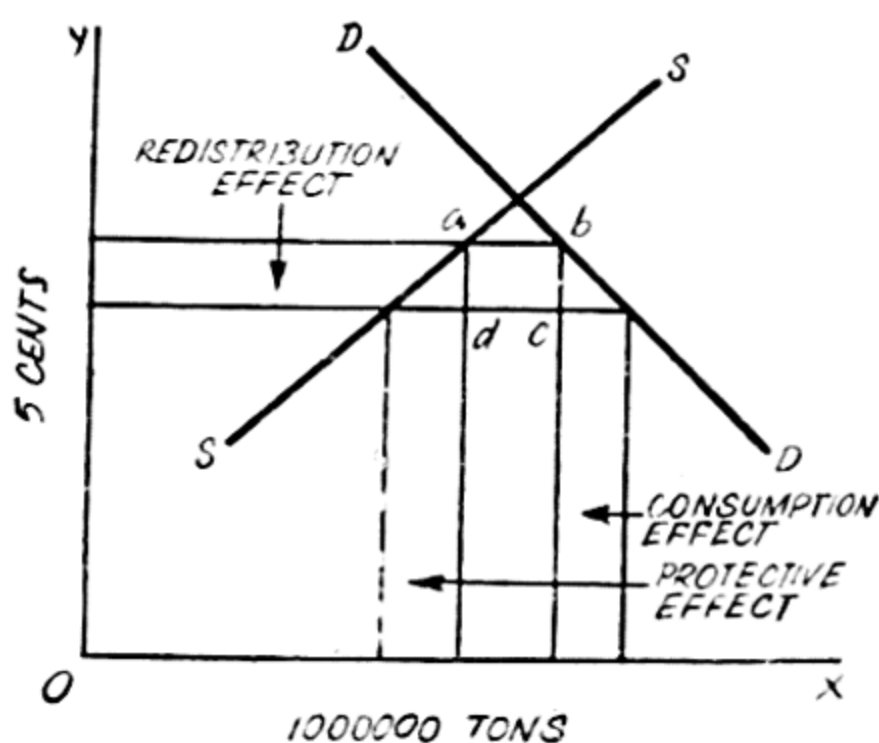
tariffs for redistributing income within a country. They achieve the desired results without or with less distortion in production and consumption. Finally, employment and balance of payments objectives should be approached with monetary and fiscal policies. If any thing tariffs can do, something else can do better. Still the movement for tariffs is strong because producer interests in particular are more politically powerful than consumer and producer interests in general¹.

QUANTATIVE RESTRICTIONS *kol Gupta*

Quotas. Quantative restrictions, usually taking the form of quota restrictions, place a limit on the importation of a particular product or group of products in a given period of time. Quotas restrict imports either by value or by quantity. In terms of foreign exchange savings, the limitations by value, will be the most predictable in its consequences.

Effects of Quotas. In case a country possesses a fair idea of the shape of demand and supply curves involved in a particular commodity and finds them not particularly inelastic, it will not find much difference whether it imposes tariffs or quotas. If the quota is set at the volume of imports which would result from the imposition of a given tariff, the protective, consumption and redistribution effects will be the same in either case. In the figure, for example, a tariff of 5 percent or a quota of 10,000 tons would each have the same effect in raising the internal price, reducing overall consumption, limiting imports and encouraging domestic production.

There is, however, one considerable difference between a tariff and

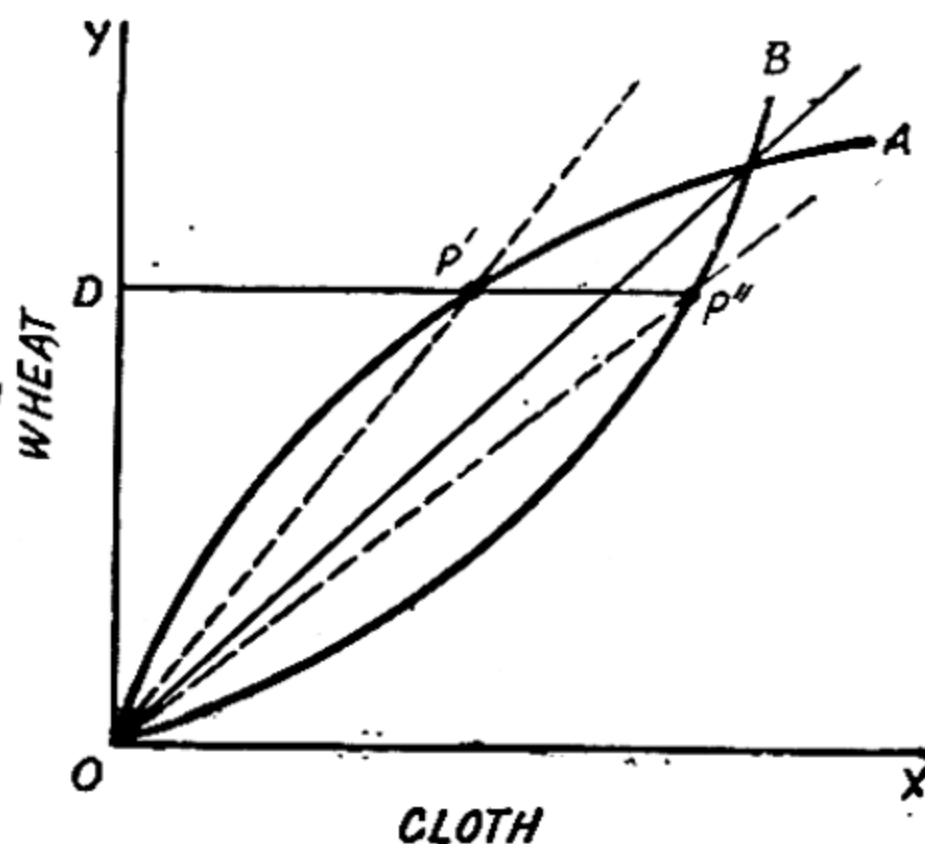


a quota even when the conditions underlying the market are known. This is in the revenue effect. Under a tariff area $a b c d$ will be collected as government revenue in the importing country. If a quota of 100,000 tons is laid down, the price of imports is greater than before.

I. Charles. P. Kindleberger : International Economics, (Homewood, Richard D. Irwin, 1968 p. 128).

Who will capture this increase cannot be determined in advance. If the importers have a monopoly of the trade and the exporters are unorganized, the importers may succeed in obtaining it. If the exporters are effectively organized and the importers not, the terms of trade may swing against the country as the foreign exporters hold up the price.

In terms of offer curves the situation can be set forth as under: If Britain, with the offer curve, OB limits its import of wheat to OD , the terms of trade between clothing and wheat may be OP' or OP'' or any price.



Like the case of bilateral monopoly—with a monopoly buyer and a monopoly seller—the outcome is theoretically indeterminate. The new terms of trade are either more favourable or less favourable to the country imposing the quota. If the importers capture it, the terms of trade are improved by a quota to the extent that the foreign offer curve is elastic.

Reasons for the Introduction of Quotas.

If the protective and redistribution effects are the same under quotas and tariffs, provided that elasticities are not zero, why did quota, come to supplant tariffs so widely in the 1930's? ¹ Kindleberger provides three arguments. Firstly, in some commodities on which quotas were imposed, supply position abroad was almost completely inelastic. Under these circumstances, a tariff could not increase the price in the importing country or reduce the volume of imports. The only effect of the tariff was to improve the terms of trade and to gain revenue for the government by taxing the foreigner. While under ordinary circumstances a country is pleased to have its terms of trade improved and governmental revenue enlarged, the countries during the thirties were more concerned with providing a fair return to agriculture and quota secured to be the ideal solution.

1. Charles. P. Kindleberger, *International Economics*, (Homewood, Richard D. Irwin 1968 p. 132).

Secondly, quotas are used widely for protection and redistribution of income because the shape of the excess supply curve in exporting countries is unknown. How much of a tariff increase will prevent a price decline abroad from spreading to the home country? It is difficult to answer this question if there is a single price abroad for domestic and export transactions. It may be impossible if foreign producers practice price discrimination and dump exports at prices lower than those in the home market. The possibilities of such dumping provides part of the inspiration for the quotas.

Finally, an administrative reason helps explain the introduction of quotas. Tariffs had lost their value as an emergency measure because most-favoured-nation clauses and other restrictions limited its efficacy. Extreme circumstances called for extreme remedies, but the tariff was by this time a fair-weather device only¹.

Quota Problem—Advantages and Disadvantages.

Most economists stress the disadvantages of quotas to the almost complete disregard of possible advantages. It is pointed out correctly that quotas found to be restrictive and administratively much more changeable and arbitrary as contrasted with tariffs, which are altered less frequently. Under these circumstances quotas are most expensive for consumers. They further establish the monopolies of the consumers of importers or reduce competition among foreign suppliers. Finally quotas introduce wholly arbitrary new dimensions into international trade. Exports and imports are determined not by the price system but by fiat. Decisions about imports and exports are made by personal decision rather than by the impersonal forces. The chances of retaliation are greater in personal decisions than in impersonal forces. Thus tariff and quota appear to share the characteristic of being directed by visible hand, quotas are impersonal with respect to what countries and what dealers may share in trade. The visible hand is likely to be guided by consideration other than efficiency and maximization. Fairness, equity and justice may be used to decide what is bought in what amounts from what countries and by whom. These considerations are not unambiguous the same way that a price is, nor is it even likely that agreement can be attained from different interests on what constitutes fairness. The use of quotas is a step backwards towards the economies of middle ages and the fair price.

These arguments are powerful. But we must give the devil his due. In the first place, quotas are being compared with international trade, not as it has been in the real world but with a model of the international trade system based on perfect competition area perhaps full employment. This is far superior to a system of quotas. During the war years quotas are used extensively. Their attraction is greater especially when the country is facing deflationary pressure from abroad.

London market in the 19th century served as a place where distressed goods could be sold at some prices. This was good for

1. Charles. P. Kindleberger, International Economics p. 134.

British consumers and for foreign consumers. It may be argued that it was hard on British producers of import competing goods and foreign consumers. But British producers of these goods had for the most part gone out of business and factor mobility was inefficient to enable the resources conserved to shift into other lines. Under these circumstances, cheaper imports improved the terms of trade and the distress sale of foreign producers were welcome to the Britishers.

In the world of less factor mobility, less specialisation and with an important volume of resources engaged in domestic production of an imported article, distress sales from abroad are less tolerable. Resources cannot be shifted out of domestic production temporarily later to be shifted back again. The tariff is a poor device to give temporary protection. The quota is under these circumstances the only possible basis for defence of the domestic industry against the sudden and drastic decline in its income which the society regards as unfair.

This is not to say that quota is not abused and brought into play in many circumstances when it is not appropriate. In some, domestic resources are uneconomically employed and should be moved. In others, what appears to be a temporary change due to a cyclical swing is really more basic and should evolve an adaptive response rather than a temporary enacting off of trade.

This is not to say either that a more fundamental attack on the problem is not superior to the use of quota. Two such possibilities are evident. To prevent depression abroad and to increase the mobility of resources at home either or both these courses of action should be undertaken too. Given the circumstances, however, resources are relatively immobile and depression abroad occurs, the economist who would abjure all use of quota fails to take account of the realities.

This defence of quota to mitigate the effects of deflation abroad must not be extended to support for their use in case of inflation at home. Deflation abroad is outside the control of the country with the balance of payments deficit. Domestic inflation is not. Quotas are inflationary. This is bearable in a world of depression. It compounds the difficulties arising from domestic inflation. The dictum that quotas are less desirable than alternative lines of action is never more in point than in the case of quotas imposed to reduce the balance of payment effects of uncontrolled inflation at home.

There is further distinction between the effects of tariff on the one hand and quota restrictions on the other. If there is a potential domestic monopoly protected by a tariff, it can charge only the international price plus the tariff. If it tries to raise the prices above this level, it will lose sales to additional imports.

To charge a tariff into a quota even without reducing the existing volume of imports, may convert a potential domestic monopoly into an actual one. The domestic monopoly can now raise its price secure from the potential competition of imports. It is of greater importance for

manufacturing than for agriculture. Liberalization is a weapon against monopoly even if a quota is replaced by an equivalent tariff.

Export Restrictions

Restriction of exports is a means of improving the terms of trade. In this case, the terms of trade are of major concern. This is in contrast with the import quotas where the principal interest generally attaches to the price effect for domestic producers or the balance of payments effect brought about by the reduction in the quantity of imports. The condition for successful gain from import quotas is inelastic of local demand and the elastic foreign supply. Export restrictions flourish when domestic supply and foreign demand are inelastic. Only in the limiting case when demand is perfectly elastic, it is impossible for a country to improve its terms of trade by restricting exports.

It is well to be clear on this point. It pays a country to burn its coffee, dump sugar in the sea, plough its cotton, kill its pigs or latter supply off the market when the demand curve facing the producers of a country is elastic. That is, it pays producers consumers, whether in the country, or abroad or the world as a whole, lose in real terms. In the case of over-production and inelastic demand, however, the redistribution of income from consumers to producers brought about by export restriction may act primarily to restore the position which existed before an increase in supply redistribution income in favour of consumers and against the producers.

Given perfect knowledge of the slopes of demand and supply curves, an export tax would be as effective in improving the terms of trade as the restriction of production or export. To this extent import and export restrictions are identical. But export restrictions schemes fail and export taxes defeat their own objects as more frequently than do tariffs and quotas on imports. The reasons are several. The inelasticity of demand is over estimated. The strength of potential competition abroad is under-estimated.

Demand is more elastic in the long run than in the short run. Given time substitutes can be found and other sources of supply developed. Since the demand involved is the demand abroad for the exports of a given country only, the monopoly must be airtight, because export restrictions can be counted a sure thing. Rubber plants in Malaya encouraged production in Indonesia. The United States attempt to keep the world price of world cotton in 1930 gave rise to alternative sources of supply in Egypt and Brazil. History is full of commodity restriction schemes which failed because a new and high price exerted an umbrella over foreign producers and encouraged the expansion of production. Brazil's attempt to maintain the prices of coffee have encouraged output in Columbia, Gautamala, Nicarrgua and lately in Africa.

Sometimes it may happen that some of the burdensome stocks accumulated by control authorities turn out to be blessings in disguise in

different circumstances. The enormous surpluses of wheat and cotton accumulated during 1930, by United States were useful in World War II.

Export restrictions have come out to be respectable substitutes for import quotas in a number of ways. Sometimes it is believed that export competition is so intense, that it leads to selling exports below costs to country's disadvantage. Export restrictions are imposed in order to prevent the loss of goods needed by a country or to keep down the price of a raw material at home. The major reason for preferring export restrictions to import restrictions is that reduction in the quantity of exports involves an expansion of exports by value. It is undertaken only when foreign demand is inelastic and expansion of the value of exports works as the balance of payments and nation income in the same fashion as income in the value of imports.

COMMODITY AGREEMENTS

History of international trade is replete with unsuccessful international commodity agreements. These agreements have their origin in the inelasticity of both demand and supply. In many of the commodities concerned which result in large price changes for small shifts of demand or supply schedules. In addition there is a claim of primary producers that the long run terms of trade run against them and give them less than "adequate, just and equitable" prices or as a U.N. resolution puts it, a less than a fair share of world's income. But even when they start out or limit the range of prices and income fluctuations, international commodity agreements end up trying to raise commodity prices. They all fail because the elasticities are high in the long run even though low in the short run. In addition, prices which might have stabilized the market under existing conditions, prove far high because of the agreement itself. Believing in the future stability of prices, producers expand output which lowers costs in turn and reduce the appropriate long run equilibrium price.

Price inelasticity of demand for primary products is due to many reasons. Some products, like wheat, rice, coffee, tea and cocoa have only a few major producers in international trade and the demand for the commodity itself is price inelastic. In others, the demand is derived and all derived demands are less elastic than the demand for the products in which they are embodied. In still other products, involuntary accumulation and decumulation bring about substantial shifts of demand from time to time but leave demand at all times price inelastic. This is because the market expectations of buyers and sellers are linked rather than independent of one another.

The short run elasticity of supply of agricultural products is determined by the nature of the production process and is low in the short run for annual crops and high over longer periods for crops produced from bushes and trees. Substantial shifts may occur as the bounty of nature varies. Whatever the reason, primary products subjects

to short run inelastic demand and supply vary widely in price. A U.N. study concludes that the average of price of 50 primary products examined from 1900 and 1950, moved annually on the average, 14 and 70.

Increased price stability has much to commend it. The difficulty is how to achieve it. In some commodities where supply is variable because of crop failures or gluts, a certain amount of price variability is useful in stimulating expansion after short crops and contraction after long, but extreme fluctuations should be avoided. These commodities lend themselves to agreements which set maximum and minimum prices, with a range between maximum and minimum quantities to be imported by the consuming countries in periods of shortage. ✓●

It evidently makes a substantial difference how wide the gap is between maximum and minimum prices and between the buying and selling prices of the stock piling authority and whether the finance for these operations comes from the exporting country or importing countries. The wider the price range, the more the instability, the higher the profits of the stabilising agency and the more the private price system is permitted or required to work. Whether finance is provided by exporting or importing countries affects balance of payment stability. Either arrangement equals affects income in the primary producing country but if stock piling is financed by the exporting countries then balance of payments gets no benefit. Infact the balance of payments may be more unstable than before. If the volume of exports fluctuates widely, foreign exchange receipts will vary despite the added stability of price. To maintain imports in these circumstances by financing unsold exports through deficit financing will inevitably exaggerate the fluctuations in the trade balance.

Similar stabilising effects on domestic incomes and destabilising effects on the balance of payments and world prices can be obtained from export taxes in periods of boom and subsidies in periods of depression. There is infact no difference of substance between an export tax and the policy of buying cheap at home and selling dear abroad.

The world is faced with serious dilemma in the area of primary goods prices. The position is satisfactory with respect neither to their variability nor their trend. The under-developed countries complain that it is futile to give them aid for economic development with one hand and to depress their commodity prices, which reduces their capacity to import with the other. But the world is far from having a solution. A group of the United Nation Experts called upon to determine what the adequate, just and equitable price was, claimed that it was the long-run equilibrium price which would clear markets over time. But there seems to be no way to determine the appropriate long-run equilibrium price, and even if these were, the strength of the producer's interests and the short run profit motive may lead to the fixing of a price above it, and the price set by the existing producers always seems to be high enough to encourage the entry of new producers whose output in time leads to the collapse of the entire scheme.

Sudh. B. (Econ. 1973)
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In short, international commodity agreements do not work. The coffee agreement of 1957 started out with seven producers and added 8 more in Latin America plus the French African Community in 1959. In 1960, other African producers joined to bring the total number of producers to 28. But the system still does not function. The world production rose despite the agreement and price fell. In 1962, a major attempt was made to renew and broaden the agreement and to police it through import controls which would exclude new from countries outside the agreement.

The demand for commodity price stabilisation continues to be insisted particularly on the part of the developing countries, which depend upon export proceeds for capital equipment purchases. In these circumstances it is idle to consider a number of theoretical questions about commodity agreements such as whether these should be commodity to commodity or cover a large number of commodities at once, whether they should be applied continuously or only for transitional periods, when fundamental structural change were being carried through to a new equilibrium position. These and similar questions demand attendance until international commodity agreements reach the equilibrium price rather than merely a higher price and until economic science finds means of determining it.

Bilateral Trade Agreements And Bulk Buying :

The disruptions caused by the depression of 1930 and the World War II led for a time to expanded use of international agreements to regulate trade. Some of these agreements have evolved from clearing arrangements required because of the exhaustion of internationally acceptable reserves to settle trade surpluses. Others arose from the quest of the government for an outlet for a given surplus or excess to a particular commodity which was scarce. Some countries like Norway embraced bulk buying and selling by governments as a means of protecting a domestic planning programme against interference from uncertainties arising abroad.

The practice under bilateral trade agreement and bulk buying contracts differed widely. In some socialist and quasi-socialist States actual purchasing and selling was done for government's account whether or not production is undertaken in government owned factories. In others, such as the trade agreements between Britain and Sweden on the one hand and the socialist countries on the other hand, the western countries merely agreed in advance to issue export permits for a list of specified materials without guaranteeing the procurement of goods in question or the prices at which they will be bought.

The claim for bulk buying to restrict ourselves to one sort of device is that it gives certainty. Certainty for the consumer is regarded as desirable since it enables him to know where he stands. Certainty for the seller is more significant, because, with an assured price, he can plan his output more carefully and he can achieve economies of scale which

may be reflected in a lower price. It is argued that bulk buying should bring lower prices in the same way that private firms offer discounts for quantity because of the certainty they afford to production.

It may be asked, however, that assurance for the buyer may not at the same time be assurance for the seller. In the buyer's market where the goods are in oversupply, a bulk contract provides a certain outlet for the seller, but involves the buyers in paying more than the market price for his supplies. In a seller's market, on the other hand, buyers get guaranteed access to supplies at reasonable prices but the seller becomes restive in selling below the world market. If the buyers use this market alternative fairly rapidly and contracts are renewed by brief pauses between, the bulk buying contracts may assist in the preservation of stability. If, on the other hand, long-term contracts and in random fashion sometimes in periods of loss and sometimes in periods of high prices, the effect of bulk buying may merely be to shift prices discontinuously in the wide range almost as wide as free market.

The clash of interest between the buyer and the seller has on occasion produced a stalemate. Since the collapse of the Korean boom in raw material prices, however, there has been much less interest in bulk buying on the part of the major industrial nations.

TRADE AMONG SOCIALIST COUNTRIES

After its birth during the turmoil of First World War, Soviet Union considered itself to be the only socialist State. It openly proclaimed its intention to smash the capitalist States ultimately. However, since its birth, it felt great fear of extermination by capitalist States themselves. Hence its primary objective was to strengthen itself so that it could withstand the pressure exerted by capitalist States and one day could be in a position to exert pressure on them. Hence trade was used as an instrument to achieve self-sufficiency or autarky. Sales of traditional exports wheat, timber, furs, manganese and so on, were pushed to buy the machinery which would make the country independent of foreign supplies. The Soviet Union succeeding in achieving its objectives except the case of rubber and wool.

However, the end of Second World War witnessed the unparalleled expansion of communism as an ideology. China, the largest populated country, became communist in 1950. By this time several East European nations had been engulfed by the tide of communism. So the socialist camp became a big family. Soviet Union could not pursue the policy of autarky. It was necessary for socialist countries to specialize and exchange among one another.

Soviet planning with its emphasis on materials balances is regarded as biased against balanced foreign trade. Plan fulfilment as a prime target means holding back on exports and speeding up imports to make good gaps in the plan. But foreign trade in independent plans in seven countries becomes even more difficult to regulate. Such regulation has

been attempted by COMECON, the trade organisation of Soviet block, it has not met any distinct success in finding a fundamental basis of trade among members. Mean while, trade continues on an adhoc basis, and even that gives rise to problems of deciding what countries export and import what commodities, at what price, and balancing the national value of exports against the value of imports on a multilateral basis.

One way out for the Soviet block could be to trade with each other at world prices. This has proved difficult in practice. For bulky commodities, it is not clear what the world price of a commodity is in Eastern Europe, until a decision is made as to whether the Eastern block would export or import that commodity to the West. The question of transport costs remain insoluble. It is not clear whether it should be added or subtracted. Even more difficult is to decide the question of quality for differentiated products. Can the East European car compare the American or Italian car in quality. One interesting finding has been made. Studies of the prices actually used in Eastern trade suggest that the Eastern countries frequently trade with each other at higher prices than those at which they trade with the west.¹ One could explain this discrepancy though trade discrimination policies followed by these countries. One could also refer to the "custom union effect" which has produced an island of higher block prices than those in the outside world. Finally one could explain this discrepancy by the intense desire to balance exports and imports and consequent arbitrary adjustment of prices after trade.

Kindleberger provides an explanation which shows his faith and preference for the western system. Hence it is rather unfavourable to the Soviet block keeping in mind this, we shall quote Kindleberger on the problem of what goods to trade. "Part of the difficulty lies in the lack of an efficient price system at home in each country." Real prices used in consumption and production differ widely because of heavy turn-over taxes, which are added to imports and subtracted from exports to make it possible to trade abroad at all at arbitrary exchange rates. But even after prices are adjusted for taxation, they fail to reflect economic values. If capital is not regarded as a factor of production, capital intensive goods tend to be relatively cheap, over-produced and exported which is inefficient for the system as whole. Planning techniques without prices, or with only shadow prices, become too complex, even with computers when seven systems have to be meshed, subject to the constraint that excess demand in one commodity in one country is matched by an excess supply in another, and that the value of all exports equals the value of all imports for each on a multilateral basis. These issues are solved in the West by prices and money. The Soviet block tries to operate without explicit prices reflecting scarcity values, and with a monetary system which is unsatisfactory so that its countries are unwilling to hold rouble balances. Thus for it is making slow work of it.

1. Charles P. Kindleberger, *International Economics* (Homewood, Richard D. Irwin, 1963 p. 139.)

COMECON has organized trade in ways variously described as "absolute advantage" or "empiricism", and resolved conflicts at the "highest political level", all the time seeking and failing to find an objective, scientific basis for international socialist specialisation.¹

Economic Warfare.

In normal peace time the State interferes in international trade to maximize its economic well-being. The State also interferes when it is faced with a war or with a threat of war. As such it may attempt to limit the output of another country, particularly of materials of war. Another State can attempt to depress markets in foreign countries for the sake of encouraging world revolution. Some other may do the opposite to achieve the success of the capitalist system. In this situation, it becomes difficult to distinguish whether a country is selling abroad to depress world prices and thus make economic warfare against capitalist countries or to pursue a comparative advantage, including, on occasion, getting rid of surplus production. Thus the Soviet Union has been accused of attempting to wreck the West by dumping wheat (in 1932) and since World War II on various occasions, tin, aluminium, and oil. While it is natural for western competitors in these products to regard the Soviet sales as politically motivated, careful observers have in each case found an economic reason for selling which carried more conviction. Nonetheless, while improbable, the possibility exists that one could use its powers of purchase and sale in international markets to achieve non-military political designs as another.

Economic warfare has been witnessed more frequently. The purpose of trade completely undergoes a change. It becomes subservient to military consideration. In war, a country aims at the complete surrender of the enemy and attempts to create maximum destruction in the enemy country. In the economic warfare, the objectives are not less harsh. They are to harm the enemy in the maximum manner. The weapons usually include blockade, preclusive buying, agreements with neutrals to cut off trade beyond the range of blockade. Preclusive buying is most interesting, since here the objective of State trading is not to acquire what a country wants but to prevent the enemy from getting access to it. In frequent cases, as in the rival attempts to buy tungsten and wolfram in Spain and Portugal, a chrome in Turkey prior to Turkey's entry into World War II, the effect of the rival preclusive buying is to divide supplies much as before, to raise the price many times, above its original relative value, and to expand output. In some cases, such as Swedish ball-bearings, purchases were made to keep supplies away from the enemy; and the goods were mainly stored. Blockade running British Mosquito aircraft could carry only a few tons of goods per trip in addition to their diplomatic traffic.

What we now witness is termed as 'cold' economic warfare. In such warfare blockade may not be imposed by force of arms, but every

1. Ibid. p. 139

attempt will be made by a country to deny to its potential enemy those goods which are of extraordinary strategic interest to the latter's armament needs. The gain in slowing down the rate of armament of the potential enemy, however, should be measured against its cost. Where no credit is extended trade is a two-way balanced affair, and the restriction of exports involves a restriction of imports. Success in the denial of exports should, therefore, be weighed against the impact of the loss in imported goods.

Economic warfare is effective if specific industries and specific programmes are hit as planned. The impact of the economic blockade may be exaggerated. More important the blockade itself may not be imposed in the whole-hearted manner. Even if it is imposed, it may not affect the surviving ability at all. The oil sanctions against Rhodesia in 1967 and against Italy in 1935 failed in their objectives. To make a blockade effective, certain conditions must be satisfied. Firstly, small shippers should not replace the large suppliers because they may be overlooked. Secondly, the blockaded commodity must be used for essential purposes. For instance, the blockade against Rhodesia failed because oil imports were normally used for non-essential purposes, which could be eliminated without harm to the economy. Finally, substitution of raw materials is made by modern technological advance. Consequently the denial to an enemy a potential quantity of materials for a particular industry might result in diversion of other resources to that industry. A developed and technologically advanced country can easily make such a transition. Thus it is important to weigh the potential gain in minimizing the position of the other country against the cost to one's own.

A country, which is not industrialised economic blockade may intensify the determination to develop industrially. As such, after industrialisation the country would become more dangerous. The better strategy from an economist's point of view would be to sell arms to the potential enemy so that he does not develop the determination to develop his own weapons and thus becomes easily responsive to economic warfare.

East-West-Trade.

Since the Second World War Soviet Union and the United States have exerted in an atmosphere of cold war with their different economic systems. It is very difficult, especially for the United States to have proper trading with Soviet Union as the former believes in the market determined prices, while the latter deals through State trading organization. The United States has imposed restrictions upon itself because of political reasons. Until recently, it absolutely prohibited trade with Communist China and Cuba. Besides several commodities could not be sold to the Soviet Union and the Eastern block. The situation has changed radically since Mr. Nixon's visit to China and the Soviet Union. There has been a persistent trend towards increasing understanding between the two giants. Still suspicions between East and West raise a few problems of

political dependence of one sided economic advantages, of predatory dumping, of grave difficulties of settling the disputes

The West feels that Soviet Union because of control of trade may squeeze a customer. This complaint was voiced by Communist China against the Soviet Union. But there are several complaints in this respect against the Western countries also. Perhaps each strong country tries to squeeze its customer if it can. The threat of ceasing supplies is very real. Both communist and capitalist countries face this danger from each other. It is raised by mutual suspicion and this threat will persist until some international agency stronger than super powers emerges.

Kindleberger mentions that the West would like to buy output of the sophisticated Soviet space organization, particularly rocketry. This complaint rests on the contention that the Western price system does not in fact appropriately reflect relative scarcities as between primary and more advanced products. It may happen that the economic prices at which various goods are traded in the West give large gains from trade to the East. But it can happen that a country's utility function is more complex, and includes not only its own income, positively, but the gains of trade of its partner negatively. In this case, for example, the West would be willing to trade with the East and enjoy gains from trade only if the gains of trade the East were taken into account. The West restricts trade with East mainly on the ground that the East gains too large an advantage from it.

The threat of predatory dumping haunts many Western countries. They feel that Soviet Union will sell oil for Western Europe cheaply and replace all other suppliers. When it succeeds in doing so, it will raise the price. But it is assumed that other companies will have business when prices are lowered and will not come back when they are raised. These assumptions are quite unreal. Perhaps the real explanation according to Kindleberger lies in the fact that Soviet oil production is excessive and the pressure to market in Western Europe comes from distress selling, which comes from excessive investments in oil and gas because of planning error.

Besides these difficulties, other problems expanding East-West-trade stem from wide differences in system, the difficulties in achieving mutual understanding, and especially the absence of surplus goods in the East available for sale. To a very considerable extent, East-West trade has been kept down by inadequate eastern supplies, while the blame has been ascribed to Western policies. Eastern countries want to purchase on credit, and there are obvious limits on how far it is safe to go¹.

Price Discrimination and Cartels.

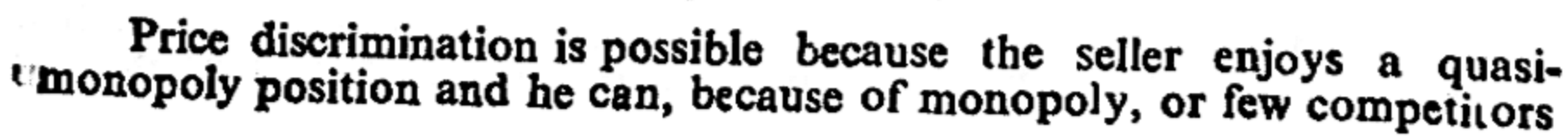
Price discrimination does not involve disregard of the price system. It is instead a manifestation of the workings of the price system under particular conditions of monopoly, monopsony and separation of related markets. Competition is imperfect when the number of firms is small

1. *Opcit*, p. 143

Price Discrimination between Markets.

If a seller has access to two separate markets and can exercise some control over price in one or both, it will pay him to sell at different prices if the elasticities of demand in the two markets differ. A policy of identical or flat pricing as two markets with different elasticities means that a higher marginal return is earned per unit sold in one market than in the other. The profit of the seller could be increased by shifting sales from the less to the more elastic market.

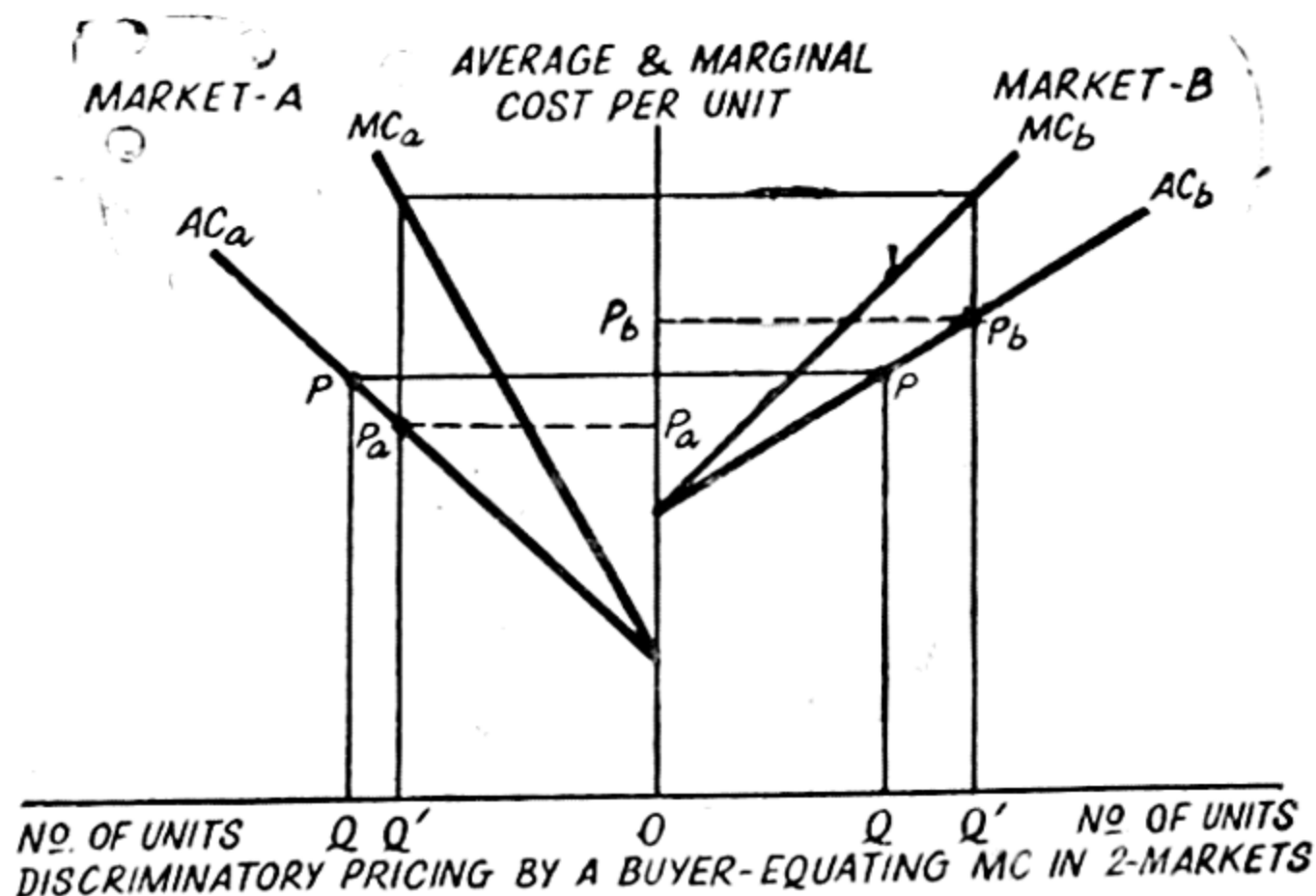
This can be shown by the diagram given below. The average and marginal revenues in market A and B are shown. The A curves are to the left of the vertical axis and run from right to left. The B curves perform in the usual manner. A shift of QQ' from market A to market B will equate marginal revenues ($Q'u = Q'w$). This will result in price discrimination, a higher price (OP_a) in A, the market with less elastic demand, and a lower price (OP_b) in B, with the more elastic demand.



or cartel agreements, fix his price. Higher, price is charged by the discriminatory seller in the market with the less elastic demand curve, and the lower where demand is more elastic. A maximum return is reached when the seller exploits to the full through price discrimination the inelasticity existing in each separate market. The limiting case is reached where the seller singles out in a separate market each potential buyer and charges him what he is willing to pay as a maximum for each unit. In these circumstances, the seller captures for himself the whole area under the demand curve. The difference in the delivered prices between two markets cannot exceed the costs of transportation between them. If the differences were wider than this amount, it would pay other to undertake arbitrage, buying in the cheaper market and selling in the dearer. On this account price discrimination is much more prevalent in heavy products than in light.

Discriminating Monopsony.

The monopsonist may be a big company, or a State trading organization which goes in for bulk buying. It is an organization big enough to take account of the effect of its purchaser in raising the prices it pays for goods. Accordingly it will shift purchaser from the less elastic



source of supply to the more elastic and pay a lower price in the former than the latter, in order to reduce its overall cost. It will equate the marginal cost of supplies in the two markets. It should be noted that the cost of transport is included in the price the buyer pays.

Price Discrimination and Public Policy.

The competitive solution is identical prices and equality of marginal revenue and marginal costs. But when a firm is large enough to affect its price, it may charge high price in the export trade than that charged

at home. It just flies itself on the following grounds :—

- (a) Profits are maximized.
- (b) The level of domestic prices is held down.
- (c) The competitive position of the specific industry may be improved.

Such discriminatory pricing results in :

- (a) Uneconomic utilisation of resources in the selling country which produces too little amount of the specific product.
- (b) Higher costs for the foreign consumers.
- (c) Incentive may be provided to develop capacity in the particular industry which is not economically justified.

Charging the same price or flat pricing is justified because (i) it does not involve the risk of adverse retaliation, (ii) it has a ring of fairness about it. Purchasers cannot complain of unequal treatment, (iii) goodwill is earned and as a result of all these long run profits are maximized.

The short run profits are high in discriminatory pricing than the flat pricing.

Dumping and Reverse Dumping.

Charging different prices in different markets is called "dumping". Originally the word dumping implied the selling by a manufacturer with an unsold supply in a market in which he does not normally sell, in order not to break the price in his own market. Similarly the case of a manufacturer who sells at a higher price abroad than at home is known as "dumping". This is called the "reverse dumping" implication being that he is dumping in the domestic market.

— Dumping is simply price discrimination. It takes place when the demand abroad is more elastic than the demand at home. It arises only because of the monopolistic element in the home market. In reverse dumping, the demand abroad is less elastic than the home demand, whether because competition abroad is less keen than at home or for any other reason. In this case, it is possible to exploit the inelasticity of demand of the foreign market by higher prices abroad than at home, balancing marginal revenue in the two markets.

Dumping may be of various kinds. Sporadic dumping occurs when a company finds itself with distressed goods on its hands which it wants to dispose of without harming its normal market. For the company engaged in the demand abroad is more elastic than the demand at home, where it wants to preserve its quasi-monopolistic position. Or it may regard the cost of the goods as already sunk (i.e. marginal costs excluding transports cost as zero), and cut its losses abroad by selling the goods for anything that can be realized.

Predatory dumping is selling at a loss (as measured by average costs but not by marginal) in order to gain access to a market, to drive out competition, or for any other short-run cause. Predatory dumping

is followed by an increase in prices after the market has been established or the competition overcome. To engage in extra costs, to advertise, to establish a distribution system, and to obtain any acceptance of the product in the new market leads to increased selling costs which is almost same as predatory dumping.

Persistent dumping occurs when a producer consistently sells at a lower price in one market than in another. As a rule, this occurs when the firm regards two markets differently from the point of view of overhead costs. Suppose that average variable costs are low relative to average total costs, and that average fixed costs can be covered in the domestic market. Additional sale at any price above marginal costs in the foreign market will increase the profits of the firm. It may then pay a firm to dump persistently. Most economists regard persistent dumping as beneficial to the importing country and harmful to the exporting country, in which consumers are charged a monopoly price.

Price discrimination, which takes advantage of different demand elasticities in different export markets might be called differential dumping; it is more nearly akin to tariff discrimination, applying different rates of tariff to imports from different countries. To achieve equilibrium of the firm, marginal revenue should be equalized in each separate market, which means a variety of different prices.

(Most economists regard dumping as a vicious policy, much more to be condemned than tariff. The government, it is felt by them, may discriminate between foreigners and citizens for common good, but the private trader in a position to discriminate, is a monopolist, in whole or in part, working for his own interest. As such, discrimination by him in foreigners and citizens is unjustified.

Cartels J

A cartel is a business agreement to restrict competition in matters of markets, price, terms of sale, conditions, and so forth. The content of cartel agreements, whether implicit or set out in formally negotiated documents, may differ. Some such as the electric light cartel, may be concerned with fixing prices; some with patents and some with conditions of sale. But the essence of them all is that competition is limited by international business agreement.

Business agreements occur in standardized products costly to transport, in raw materials and some primary products subject to inelastic demand and inelastic supply, and in some highly differentiated goods such as pharmaceuticals, and complex chemical such as rayon, nylon, synthetic rubber and dyes which operate within the sphere of patent control. In addition, shipping services themselves are likely to have their rates regulated by so-called shipping conferences.

In most of the products covered by these areas, entry of new competitors is limited, and exit is unlikely.¹ Entry may be limited because of a natural monopoly, as in mercury, nickel, sulphur, potash, etc;

because of the large amounts of capital needed to get started from scratch, as in oil or aluminium ; by government regulation, as in pepper, quinine, rubber, coffee or by patent control, as in dyes, photographic supplies, optical instruments etc. Exit is limited by the fact that large amounts of capital are involved and the governments in question cannot afford to withdraw quietly from the business in case of losses. The result is that when price competition does occur it is likely to be cut throat in character and self-defeating.

Cut throat competition is a phenomenon of oligopoly or a limited number of buyers. A predatory price cutter can sometimes free other concerns out of business if he commands larger resources than his competitors, but price competition is self-defeating. In the oligopolistic case, price cutting generally ceases through an agreement to maintain prices well before any firm has come to the end of its resources. The perfect competition can hardly exist in the oligopolistic industry.

The economist would prefer the midway of workable competition. This implies that price cannot get too high because new entrants will be encouraged to come into the industry and may do so unhindered by capital costs, patent restrictions, lack of access to raw material, or other barriers ; and that in which price cannot get too low because existing firms will be encouraged to quit and to shift their effort into other more profitable lines.

Cartel Policy.

Sometimes it is said that cartel cannot endure without government support. Sometimes private cartels are regarded superior to inter-governmental agreements because private cartels dissolve under the impact of diverse interests of individual producers. Public policy could take three shapes ; it could ignore them, attempt to break them, or adjust to them softening their worst features.

The classical policy of laissez-faire implying no regulations by authority ignores cartels. But this policy is outdated. The assumption that cartels can be broken up is more idealistic, because it is difficult in practice. The third alternative would involve publicity for written agreements among firms and certain limitations on the content of such agreements, such as forbidding the decision of markets and restriction on entry. It also would involve restraint in the exercise of monopoly and oligopoly power. In the present state of economic theory, however, no consensus exists as to how cartels should be regulated.

Commodity Price Stabilisation.

The less developed countries are concerned about commodity prices in two ways : short run instability and their trend. About instability was made in 1952 by a United Nations study which pointed out that from 1900 to 1952 primary product prices rose or fell from on the average of 14 percent a year. A change in price does not necessarily imply a change in export proceeds since the volume of exports can move in the other

direction, but the data showed that the volume of exports tended to move less than price, and often in the same direction, to compound the instability.

It has been widely agreed that instability of export proceeds complicates the problem of economic development by interrupting the flow of imports, and hence of domestic investment. Care studies by Mac Bean, however, find investment in the less developed countries to be insulated from instability in export prices by a number of factors: offsetting volume changes, expenditure for imports out of foreign exchange reserves, and restrictions on imports of consumer goods. However, instability is definitely undesirable.

The causes of instability in primary products can be summarized as changes in demand or supply reacting against inelastic supply or demand curves. Moreover, planting can take place in response to one set of price signals, and harvest occur under difficult circumstances. With products of long gestation, such as tree crops, and including especially coffee, cocoa, rubber, there are strong coowebbs or lagged responses. When the price rises today, planting cannot affect supply for five years or more. This may mean five years of high prices, and high planting before a large volume of supplies presses on the market and drives prices down.

In minerals, the instability tends to arise from variation in demand which is subject to cyclical swings and from speculation, both of which run demand up and down against a relative inelastic supply. In some commodities, particularly sugar, much of the world output is traded under preferential arrangements outside the world market, so that the spill over of changes in natural demands and supplies impinges on a relatively small world market which exaggerates price fluctuations.

Remedies for Price Instability.

Several remedies for price instability have been offered. These include (a) the schemes for fixing maximum and minimum prices, (b) buffer stock plans, (c) export quotas and (d) various financial measures.

The International Wheat Agreement fixes maximum prices at which the exporting countries guarantee to make stipulated amount of wheat available to the importing countries, and minimum prices at which the importing countries agree to purchase fixed amounts of wheat from the exporters. The range between is left for the price system to operate in, to encourage output when crops are short, and to discourage them in periods of glut. The system can work only if governments intervene. When a limit is reached, to make available exports at the maximum price as to purchase imports at the minimum. In fact prices under the wheat agreement have been almost continuously at the maximum, so that the United States and Canadian governments have been obliged to make wheat available for export below domestic prices in the United States. The narrower the range between maximum and minimum prices,

of course, the more nearly the system approaches a system of export and import quotas ; on the other hand, the wider the range, the more nearly this scheme resembles the free market. The object of the exercise is to forecast and agree on a range within which price will fluctuate most of the time, with the limits coming into operation occasionally to moderate extreme swings. This objectives, however, has not been achieved.

Buffer stock arrangements call for an international authority to set a range of prices, and to buy the commodity at the minimum and sell at the maximum. If its funds are too small and the price rests long at the minimum, it will of course be unable to hold the price up. If its stocks of commodity are limited, and the price stays long at the ceiling, it will be unable to hold the price down after it runs out of supplies. The longer its resources, the more effectively it can carry out its tasks. The Tin Schemes ceased to stabilize when it ran out of tin and was obliged to let the go up.

Export quotas are perhaps more a device for holding up the trend of prices than for stabilizing variation around an equilibrium level. In coffee, agreement among major producers of Latin America and Africa limits the amount that can be exported, although if the price were to move up, the enlargement of quotas would be quickly accomplished in view of the heavy burden of accumulated stocks. The need for an international agreement arose because export restrictions by the major supplier, Brazil, encouraged expansion of output and even new entry in part of other Latin American countries. The central feature of the agreement is that quotas are policed by the importing countries.

One question raised continuously by the less developed countries has been why was it necessary to deal with commodity agreements one at a time, whereas these were apparently economies of scale and room for bargaining, in dealing with more than one, and even with all major commodities in international trade. The F.A.O. people have talked of "planning" the flow of primary products in international trade. One suggestion is to establish commodity backing for international money, either for its own sake, or as part of monetary reform.

It is difficult to the point of impossibility to make commodity agreements function effectively in a single commodity. As professor Johnson says the whole trick is to estimate the long run equilibrium price. A United Nation group of commodity experts pronounced that the adequate, fair and equitable price sought by the less developed countries was in fact the long run equilibrium price. It is difficult to estimate the equilibrium price and to plot its future course, is something else again. Besides, producer pressures have been universally more effective in pushing for a high price than consumer or governmental representative in holding price to the equilibrium level. The result is that there are strong incentives, to expand, to violate the restrictions, or to undertake new production in new areas outside the agreement. The result in the long run is over-production and breakdown.

The rationale of dealing with many prices at once is that each country will be willing to agree in price supports for the other fellow if he is getting his share. Presumably it is easier to negotiate the whole network of primary product prices than to take them or one at a time.

Implications of Free Trade

The classical writers argued that the free trade might generally be expected to secure the highest possible degree of economic welfare. We shall examine the implications of this proposition.

Free traders stress the advantages of free trade as a means of securing both the maximum possible economic output and the best possible allocation of goods for the consumers. There are gains resulting from reallocation of factors of production or of consumption goods. There might be in addition efficiency gains resulting from a more efficient substitution of factors within a firm or industry. These gains take two forms. First, there is a gain from increased output. Second, there is an improved consumption pattern.

Let us first take free trade as a means of securing the maximization of output. If Britain has a comparative cost advantage in producing cars while Denmark has a comparative advantage in producing butter, in Britain more sacrifice in terms of alternatives forgone is required to produce given amount of butter than in Denmark. If prices in Britain and Denmark reflect relative internal production costs, then in Britain cars will be relatively cheaper and butter relatively dear. While in Denmark cars will be relatively dear and butter relatively cheap. Now if trade is opened up, in the absence of transport costs, Britain can gain by concentrating on more of its resources on car production and importing part of its requirements from Denmark. Denmark can gain by concentrating on butter production and importing cars from Britain. The shift of resources in Britain from butter into car production and in the reverse direction in Denmark results in an increased world output of both cars and butter. These advantages will accrue if comparative cost advantage is reflected in the price rates of these products. But export duties will raise the price of cars or of butter and some or all the advantages of international division of labour may be lost.

In welfare economics we are concerned with the marginal social cost and not with the marginal private cost. But in a free market economy production decisions are taken on the basis of the private costs. These private costs might well diverge from social costs. A motor car might cause considerable congestion on the roads within the vicinity. While dairy farming with the gradual supply of milk might create a social benefit not reflected in the price ratios. The private marginal cost does not take into account any of the social economies. There may as well be other reasons which prevent free trade from leading automatically to output maximization.

Firstly a producer's monopoly in one industry might cause the price of that product to be higher than if monopoly were absent. Secondly, a production subsidy on some products and not on others could cause price-ratios to diverge from cost ratios. Thirdly, differential rates of internal taxation might bring about a divergence between price and cost ratios. The other conditions making possible the divergence include lack of market imperfections, the possibilities of internal economies and diseconomies and the price or wage rigidities. If one or more of these distortions is present, price ratios will not accurately reflect marginal cost ratios. There will be a distortion of trade. We can express the equilibrium position as follows. In each country

$$\frac{\text{Price of cars}}{\text{Price of butter}} = \frac{\text{The marginal social cost of producing cars}}{\text{The marginal social cost of producing butter}}$$

However, in so far as authorities successfully offset some of these distortions by taxation and other reasons, they are not interfering with the free operation of market forces, but restoring the market situation to what it would have been in the absence of distortion. Prof. Meade describes policy measures which aim to restore the true laissez-faire position as constituting a policy of modified laissez faire. If laissez-faire leads to monopoly—as it might—the result could be less than an optimum one. Perhaps the creation of an ideal trade position sometimes requires more than simply the creation of laissez-faire.

FREE TRADE AND THE OPTIMISATION OF CONSUMPTION

Free trade also secures the optimisation of consumption in the absence of distortions. If Britain is well endowed with the factors necessary for producing cars relatively cheaply, in the absence of trade British residents will be faced with relative abundance of cars and relative scarcity of butter. The opposite will be the case in Denmark. In this situation, Britain is prepared to sacrifice more cars in order to get additional supplies of butter than would Danish consumers. To British consumers marginal utility of butter is higher in terms of cars than to Danish consumers. Accordingly the price of cars as compared to the price of butter will be lower in Britain than in Denmark.

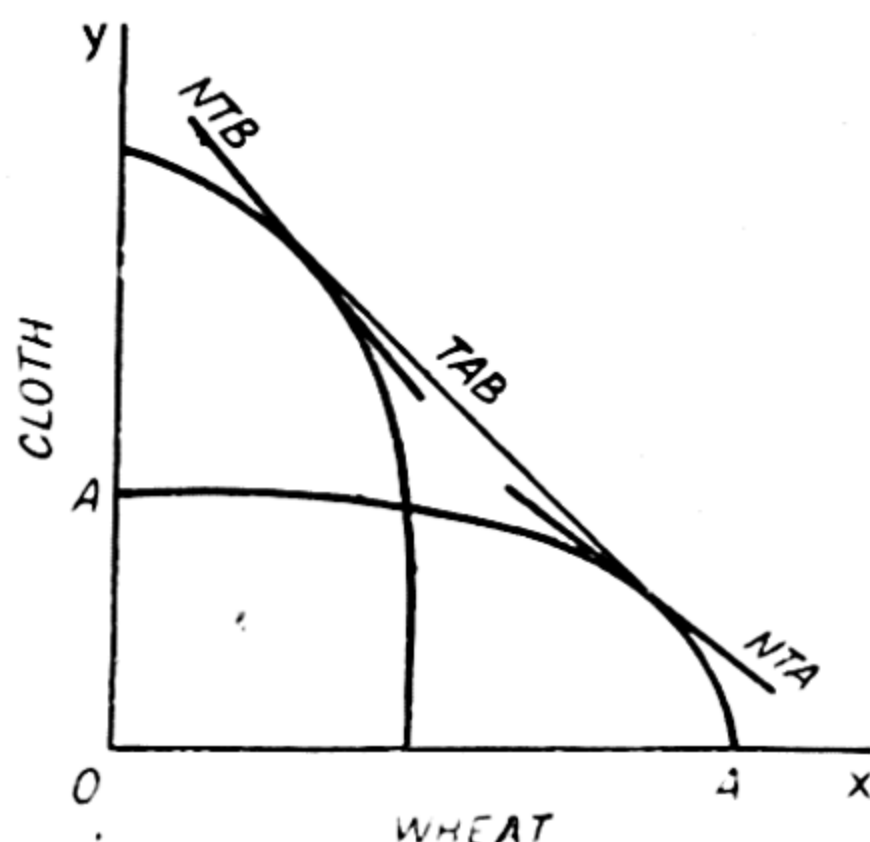
If trade between the two countries is opened up, Danish residents take advantage of the relative cheapness of British cars while British residents take advantage of the relative cheap Danish butter. Now British residents gain since the marginal utility of butter in terms of cars to them is high, and trade enables to obtain butter on most favourable terms. Danish consumers also gain since in their case marginal utility of car in relation to that of butter is high. The flow of cars from Britain and that of butter from Denmark enables consumers in both countries to improve their consumption pattern. It should be noted that improvement in consumption occurs irrespective of any change in output of either country. No movement of factors from one industry to the other industry takes place, yet free trade enables the residents in both countries to obtain greater satisfaction from the spending of a

given income. But as in the case of output maximization, the advantage from free trade will occur to the consumers only if in each country price ratios accurately reflect marginal utility ratio that is if in both countries

$$\frac{\text{The price of cars}}{\text{The price of butter}} = \frac{\text{The marginal utility of cars}}{\text{The marginal utility of butter}}$$

The imperfections in the market conditions or the distortions made by the government may not let this happen and divergence between price ratio and marginal utility might occur. If this thing happens, trade, then, does not necessarily create optional condition for consumption.

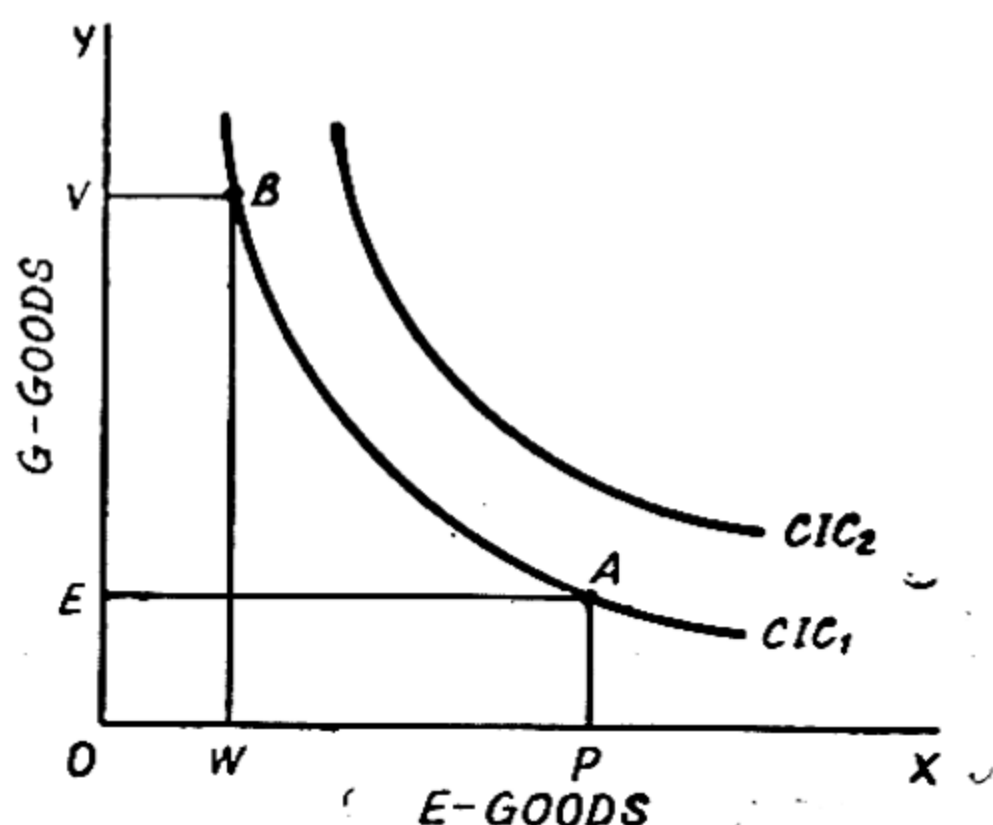
In the optimum situation then the domestic rate of substitution



between two products in consumption will equal both the domestic rate of transformation and the price ratio. AA represents A's production possibilities frontier for wheat in terms of cloth and the line TAB the international exchange ratio between these products. In the absence of foreign trade, domestic production takes place at a point where NTA is tangent to the curve AA . But given the trade, consumers in country A are able to move the line TAB . If they move to the point which is above and to the right of the point of tangency of NTA with the production frontier AA , they are clearly better off as a result of trade. They can consume more wheat and more cloth.

The concept can better be explained with the help of community indifference curves developed by Leontief, Kaldor and Scitovsky. Kaldor has defined community indifference curves as the locus of points representing a constant real income for the community as a whole. In the figure CI_1 is the indifference curve for citizens of country E. The total satisfaction yielded to the community at point A is equal to that at point B. The community is indifferent whether it consumes OE

of goods + OP/E goods or OV/G goods + OW/E goods. Of course



some citizens might prefer combination B to A. To the community as a whole any combination of goods represented along CIC_2 is preferable to CIC_1 . Some interests might object to the change in the assortment of goods represented by a change from one position to another. But since the total quantity of goods is greater, those who gain can compensate those who lose while still remaining better off than before the imposition of tariff. But of course such compensation rarely occurs. The progressive income tax, and transfer payments to the needy who may become unemployed, go a short part of the way to provide compensation. But for the rest, the compensation principle remains a pure hypothesis.

Provided that the price system works efficiently to produce a material optimum, there is no doubt that free trade produces a welfare optimum, either with equal weights for country and income recipients within countries or with the compensation principle, also between and within countries. But this is trivial truth. Every country has rich and poor and some countries are richer than others. From the free trade position then, it would be possible to improve tariff barriers and other interferences with trade which would improve welfare within and between countries. This is not to suggest that any interference with free trade improves welfare. Some trade barriers transfer income from the poor in the protecting countries to the rich within their borders, and internationally from impoverished countries to wealthy. Unless one knows the distribution of income, there is just as much reason to believe that a movement away from free trade will worsen the welfare position on that it will improve it.

Firstly, the free trade position tends to produce overall more income. For any given distribution more is better than less; for any random distribution, moreover, more is better than less. Since there is no

presumption that free trade worsens the distribution, there is a presumption that the total welfare position is superior when efficiency is higher than when it is lower. Secondly, the rich are more likely to have political power and to exercise it than the poor. In consequence tariffs are likely to favour the rich, and the removal of tariffs, the poor. If the internal welfare function calls for shifts of income from rich to poor, there is a second presumption in favour of freeing trade. The sum total of these two presumptions, however, is not sufficiently high to make an overwhelming case.

Part of the difficulty is that the price system both allocates resources and distributes income in the country as well as internationally. It then tends to produce a maximum of efficiency, to the extent that it operates effectively, and achieves a distribution of income and welfare between countries. This welfare distribution is not necessarily the optimum. For the same distribution of welfare, free multilateral trade produces more welfare all round than autarchy.

The market in a competitive society represents a collective judgement different from the arbitrary decisions of government, monopoly, or a foreign country. An adverse decision administered by the market gives less ground for retaliation through market forces or through extra market action. Thus, the strongest arguments for free multilateral trade with considerable degree of competition is that it gives an objective basis for the allocation of resources and the distribution of income both nationally and internationally.

However, if a country is more advanced technologically than the other and of greater economic (+ political) power, then free trade may represent an optimum position for the existing distribution of income, but welfare may be capable of increase through a redistribution of income brought about by trade barriers. If tariffs are justified by the international redistribution of income from a rich country to a poor, the alternative method is to adopt free trade and international income transfers. If the country agrees that welfare should be transferred to the tariff imposing country, let the country which has a tariff applied against its products adopt an offsetting subsidy. The price distortion produced by the tariff will be concealed by the subsidy. One country taking imports and the other country subsidizing them is equivalent to a subsidy from the second to the first country, or an international transfer.

For example, at the United Nations Conference on Trade and Development in 1964 the developing countries suggested the removal of high taxes on coffee, tea and cocoa imposed by the European Countries. Originally it was thought that it would expand consumption and developing country's exports. But some argued that removal of import taxes by Europeans will be replaced by export taxes imposed by the developing countries. Thus Europe would lose revenue and the developing countries would gain revenue. Production and consumption

would still be inefficient, but the shift of tax revenues from the importers to the exporters would be equivalent to foreign aid. In short, the inter-governmental economic assistance is superior to the optimum tariff, as it accomplishes that sought after transfer of welfare without distorting production and consumption. Thus the conclusion ; there is nothing a tariff can do that something else cannot do better.

The German School has consistantly regarded free trade as the ideological weapon of the dominant country. This, to a large extent is a function of the value judgments. If these call for a redistribution of income from the rich to poor country, the free trade optimum position in material terms would not represent the desirable position in terms of welfare.

Free trade is necessarily non-discriminatory trade. And the case against discrimination is a solid one. If the less developed countries require help to get a start to achieve economies of scale, subsidies are better than tariffs that are relaxed in a discriminatory fashion. Perhaps even better than export or manufacturing subsidies by the developing countries would be import subsidies by the developed country, having the international distribution of welfare in mind. This is perhaps perfectionism. But non-discriminatory trade in which imports are bought in the cheapest market and sold in the dearest to the extent needed to equalize prices (adjusted for transport costs) is the efficient ideal. If the price system is allowed to produce efficiency and transfers are undertaken to achieve international equity, the slogan of "trade, not aid" -which would distort trade in order to redistribute welfare better-does not stand up.

THE CASE FOR MULTILATERAL TRADE

In a world of more than two countries the case for free trade becomes a case for multilateral trade and convertible currencies. If free trade takes place only between pairs of countries and, because of inconvertibility, each segment of period trade must be in balance, the over all criterion for a free trade maximum of efficiency is breached. Goods will be bought in markets other than the cheapest and will be sold for less than the dearest price. This follows because of the necessity to balance. If a single pair of countries shows an export surplus for A and an import surplus for B, will all buyers and sellers maximizing their gain, balance will require the redistribution of A purchases from a cheaper source to B, or a shift of A sales to a less profitable market than B.

Multilaterlism requires convertibility. The export surplus earned by A in B's currency must be converatible into C's exchange to require the gross deficit incurred by A in trade with C. The difficulty in a world of inter-connected trade balances is that the maintenance of convertibility of a country's currency is not solely within its capacity. The currency of the country with which it has export surpluses must be convertible if it is going to meet its gross deficits. In a system of inter-locked export and import gross balances, convertibility requires that

each country maintained overall balance simultaneously or that any country with a net deficit have reserves which it is prepared to spend, in a medium of exchange acceptable to the country or country with which it has gross deficits.

We may adopt an historical approach and conclude with a quotation from William Woodreiff's "Impact of Western Man": "Especially important in England was the ideal of 'Free Trade.' 'Free Trade' was identified with civilization; out of greater international co-ordination would come the economic cosmos of the world; 'Free Trade' was peace and progress; 'Free Trade' would provide a natural harmony and order in human affairs... Britain in its trade policy was by no means altruistic; it was not in regard for great economic truths or high moral purpose that led to abandon the protection of its agriculture, industry and shipping: it was the hope of economic gain. Yet some of the noblest and ablest minds in Britain believed in the dream of 'Free Trade'.....and not for pecuniary reasons alone.....Free trade proved to be an illusion. Its fault was the overwhelming importance it gave to economics: especially in its attempt to apply to the world something that was built up on premises specifically English. But it was never a mean illusion, and it helped and strengthen the commercial-ties binding nation and nation....."

ARGUMENTS FOR PROTECTION

In spite of the intellectual case for free trade, much of the history of trade between countries consists of attempts to impose barriers on the free movement of goods between the nations. Some arguments for protection are non-economic. e.g. the establishment of a domestic aircraft industry is often supported by political rather than economic arguments. Undoubtedly there are many cases of this kind, where political considerations must be given due weight but the economic considerations should always be balanced against the political benefits of a project involving protection.

Spurious Arguments.

Haberler speaks of these arguments as untenable. Among such arguments is the plea that international trade is fair only if the domestic tariff attracts the low costs enjoyed by foreign producers. If this were taken to its logical conclusion all international trade arising out of cost definitely would cease.

Almost equally untenable but to many people emotionally attractive is the idea that it is immoral for a country like Britain to import the products of cheaper countries, not because this trade is injurious to British interests, but because it is harmful to foreign labour. It is morally wrong for British consumers to encourage the growth of sweated labour industries, in one sense countries. The fallacy of the argument is that low paid workers in foreign countries will be even poorer if importing countries refused to buy their products. If abnormally high

profits are being made out of the sweated labour abroad, these might theoretically be a case for international action among importing countries to insist on reasonable working conditions by refusing to bring the products of sweated labour unless the conditions were improved.

It is extremely misleading to make money wage comparisons between countries without taking into account also the differences of labour productivity. Thus GATT has estimated that in 1964 Italian productivity per worker in cotton yarn manufacture was one quarter of that of U.S.A. In India, production was only 17% of the U.S.A. Furthermore, in some sectors of production it is misleading to compare only direct labour costs, there are only a few products where other costs can be neglected. For example, according to the GATT study, in Hongkong direct labour element in yarn production accounts for less than 10% of the cost of the final product. Although many employees in low wage countries may be working in bad conditions for poor pay, this is not universally true. Often workers in the export sector enjoy conditions more favourable than in factories catering for the home market.

Let us speak of some more tenable arguments. Amongst those to be taken seriously is the infant industry argument. Among free traders, the infant industry argument has traditionally been regarded as one of the most acceptable justification for interference with free trade. The basis of the argument is that a country might have a potential comparative cost advantage in the development of a certain industry. But simply because of an earlier start the industry had been developed in another country to a point where it would be impossible for a newly established industry to compete with it. In this situation a tariff might be necessary to make possible the development of the industry in the country where it has the potential cost advantage. In such a case refusal to grant protection is tantamount to neglecting the potential advantage of an international division of labour based on comparative cost differences.

There are various reasons why in the absence of a tariff a new industry in which a country has a potential cost advantage would never be established. In the first place scale economies might be impossible while the home market is supplied from abroad. Secondly, a country might possess a labour force potentially superior to that of another country in a particular occupation. But several years of learning might be required for potential skill to become actual skill. In such a case tariff provides a period of protection in which these skills can be developed. Thirdly, if the protected industry is sufficiently large, economies external to the firm might be reaped. For example, if a country's engineering industry is of sufficient size, it becomes worthwhile establishing technological colleges and research centres. These institutions produce a feed back leading to further economies for the engineering industry. Fourthly, a tariff might assist industries other than those directly protected. If protection results in expansion of

domestic industries which in turn leads to lowering of costs and prices, firms in industries using the products of the protected industry also gain.

The theoretical validity of the infant industry argument has hardly been challenged. Free traders stress that, it is generally difficult to identify in advance industries in which a country has a potential comparative advantage, there is also the danger that the tariff protection once granted becomes difficult to remove. Who is to decide and by what criteria, when an industry can stand on its own. For these reasons free trade economists are reluctant to approve tariff building on infant industry grounds. Once an infant always an infant.

Often it is argued that since an industry might make substantial losses for a period of years while it is establishing itself and before it begins to yield a profit. The community should support it during its loss making infancy. Now if this is the only reason for protecting an infant, it is not a very strong one and if the industry is expected to make a profit eventually unaided, there is no final reason why it should be subsidized by the state.

We can then summarize the criteria that must be satisfied if the infant industry argument for protection is valid by stressing these considerations. First, economies resulting from protection must be external to the firm. Secondly, there must be some dynamic element in the model, that is to say. competitive position of an industry must be expected to change over time following the granting of protection. Finally, the present costs of protection must not exceed the size of future gains.

This argument becomes stronger when it is applied to under-developed countries. Almost by definition, the under-developed country is likely to be reaping the full gains from its potential comparative cost advantage. If the country does not exploit to the full its comparative cost advantage, not only the country but the world as a whole is a poorer place. Accordingly the case for protection as applied to the less developed countries does not deny the validity of the principle of comparative cost advantage. It rather argues that a better distribution of world output and resources might eventually be secured if the country is given the opportunity to develop industries in which it has a potential but not yet an actual comparative cost advantage.

Protection might enable an infant industry not only to reap internal and external economies of scale but also to gain advantage from the training up of a skilled labour force. When a range of industries is protected, the gain is likely to be even greater. The forward and backward leakage effects, i.e., effects on using or supplying industries, will be even stronger. There might occur certain lateral and horizontal effects. These occur when the growth of an industry increases the demand for complementary products, e.g. the development of a bicycle industry is likely to encourage also the growth of firms making small dynamoes, plastic saddle bags, etc.

THE RATIONALITY OF A DOUBLE STANDARD OF MORALITY IN INTERNATIONAL TRADE

All underdeveloped countries have a major interest in maintaining and increasing their exports, though as far as possible along more remunerative lines. All of them, furthermore, are compelled to use the whole of their export proceeds, foreign credits, and aid so as to keep imports up to the highest levels. From this point of view import restrictions in underdeveloped countries are simply shift of import demands from some commodities to others, and generally to goods needed for economic development. They do not imply a diminution of total imports. Their import restrictions and export subsidies do not, therefore, decrease, total world trade.

Their dependence on high export proceeds and their need to use them all for imports are caused by political necessity of economic development. Import restrictions are forced upon them because of their development policy in the context of their unbalanced economies. Besides, their protection does not cause a fall in their total imports, should make it easier for the rest of the world to recognize as legitimate the desire of underdeveloped countries to apply a policy of protection.

On the other hand; protection in an advanced country, with no foreign exchange worries will, however, restrict total world trade, since in such a country there is no mechanism whereby a restriction of the imports of one group of commodities is automatically compensated by an increase in imports of another group. The United States has herself followed a policy of protection though she has urged others to liberalize trade. George F. Kenan exposes the United States policy in the following words "Economic protectionism is not only an anomaly but it is a ridiculous and ignominious expedient for a nation of our vigour and stature. What was right and necessary for a struggling underdeveloped country can be a form of infantile escapism for a strong and ostensibly mature one."¹ Professor Jacob Viner makes the same point more bluntly, "We should not use foreign aid as conscience-money payments for our tariff" and ; "A reduction of our trade barriers, which after fifteen years of being whittled away still remain formidable, can be of greater benefit to other countries than all the much-advertised grants, loans and technical aid."² Thus, there is sufficient ground to believe that American trade liberalisation is very strongly criticised in the rest of the world. Besides she can afford it and she would gain in the long run as a consequence of her liberal policy.

But we cannot similarly say that underdeveloped country should relinquish import restrictions and abstain from export subsidies because it would be in the interest of the world. On the contrary it is in the general interest that they should be able to develop their economies as

1. George F. Kenan, quoted by Gunnar Myrdal, *An International Economy* [Newyork, Harper and Row, 1956 p. 290]

2. Prof. Jacob Viner, quoted by Gunnar Myrdal, *Ibid*, p. 290.

rapidly as possible, shortage of foreign exchange and, consequently, interferences with their foreign trade, are incidental to a policy directed towards this goal¹. In this connection one may doubt whether absolute equality prevails between nations. If it does not prevail, it should not be assumed to prevail for the sake of behaviours. In such a case behaviour following on the presumption of equality would be unjust, unequal and arbitrary. Equality of treatment is equitable only among equals. All that the under developed countries ask is that in the name of reducing barriers to international trade, they should not be denied the fullest opportunity to develop their economy and to choose and to decide for themselves the most appropriate measures for the purpose.²

In this connection the best that the developed countries could do for developing country would be to use their bargaining power against them with greater consideration and, in particular, to stop virtually forcing them to import goods which they do not want, either because they can produce at home or because they feel that they have no place in a national programme of imports for economic development. Such a consideration in commercial policy would be a substitutes for the aid and credits which they are not getting.

The main point is that developing countries are quite in a special position as long as they have not caught up with the developed countries or for this reason a double-standard morality in international trade is rationally motivated³. They have not only good reasons but are virtually forced to control their imports and subsidize their exports—indeed to practise systematic protection—if they are not to give up their drive for economic development. Their contribution to raising the level of world trade is to do every thing they can do to increase their exports along the most promising lines in order to make space for greater imports—which they are also bound to try to do so—and to handle all their economic policies, including commercial policy, in such a way as to secure the maximum rate of economic growth.⁴

Why Protection in Developing Countries ?

The developing countries are engaged in the process of economic growth. This, to be faster, involves large imports of capital goods from the developed countries. Exports of developing countries remain the same or grow at a very small pace. This leads to foreign exchange difficulties. The way out for the developing country is to impose import restrictions and save the necessary foreign exchange. The need for import restrictions is genuine. They can be fair about it if they limit these to consumption goods and especially to luxury goods, and give free entrance to imports of capital goods.

1. Gunnar Myrdal, *Op cit*, p. 291.

2. Sir, N. Raghvan Pillai, quoted by Gunnar Myrdal, *Ibid*, p. 291.

3. Gunnar Myrdal, *Ibid*, p. 292.

4. Gunnar Myrdal *Ibid*, p. 292.

Besides this immediate reason to preserve balance on foreign exchange front, there are a number of reasons flowing from their peculiar circumstances that justify restrictions for protection purposes in developing countries.

The developing countries face the difficulty of building internal demand imultaneously with supply. Import restrictions afford a means of creating the necessary demand for a particular domestic industry. They create a sizeable internal demand for a particular commodity, without the necessity of waiting for the slow and difficult growth of entire economy. Further this way is simple to operate and can be adjusted from time to time and the actual expansion of domestics production.

Secondly, underdeveloped countries lack the industrial basis which implies a great difficulty for economic development. But this fact also leads to increased external economies from an individual investment—the advantage accruing to others and mostly future industrial enterprises. This should also be a sufficient reason for subsidizing industries. Not simply the external economies increase, but productivity of labour increases and a balanced regional development takes place.

Thirdly, the existence of large and almost permanent surplus makes it vitally necessary to draw them into production. The produced goods could have been purchased cheaper abroad but they then would not have created employment. From a national point of view the differences between what the workers actually produce—measured in terms of the prices of the excluded imports—and the decrease in total production caused by their withdrawal from their previous unemployed status (which might be zero or even negative) is a clear gain, though part of the gain will be a higher level of consumption of workers drawn into employment.¹ The existence of surplus labour in the export industry as well as in the import-competing industry will motivate an extension of investment and production beyond the limit where wage costs are fully met by the export proceeds. This becomes important in seeking to develop new export lines on directions where demand elasticities are high and the demand trend rising.

Fourthly, the structure of internal costs and prices in underdeveloped country tends to be lopsided as between industry and agriculture in a way that hampers industrialisation, if industry is not protected and encouraged by fully compensating import restrictions and export subsidies or by a system of multiple exchange rates having their effect.² The gap between the real earnings of agricultural and industrial worker is really wide and consequently differing labour costs between industry and agriculture afford a rational reason for industrial protection.

The Secretariat of the United Nations Economic Commission for Europe views the issue similarly when it says."

1. Gunnar Myrdal, *International Economy* [Newyork Harper and Row, 1963 p. 277]

2. Gu nar Myrdal, *Ibid*, p. 277.

“The case for industrial protection in the relatively retarded countries of Southern Europe goes beyond the traditional “infant industry” argument. It has rather to do with the fundamental lack of balance between industry and agriculture in these countries. The existence of vast surpluses of manpower in agriculture creates a situation where money costs of production in industry are higher in relation to agricultural money costs than is warranted by comparative real costs in the two branches of the economy. Under such conditions, the exchange rate at which the foreign account tends to be in balance would be one at which industrial costs tend to be systematically non-competitive with foreign costs, and vice versa for agriculture.”¹

All these lead to the conclusion that investment is less profitable in less developed countries and hence may not be sufficient. In fact the essence of the situation is that the market forces do not themselves engender development. Therefore, interferences in the price system are called for in order to make investment and production along selected lines profitable. If successful these interferences will release a cumulative process with a momentum to continued development.²

Many solutions are possible in order to start and sustain the development process. One method could be to give direct subsidies out of state treasury. But this would be difficult to implement. Taxes in sufficient amount would never be collected. Besides, the developing country already has to go for import restrictions because of foreign exchange considerations. Thus protection becomes the chief desire to accelerate development.

The objective should be to attain self-sufficiency in an increasing number of production lines. Export subsidies are apt to meet more dislike abroad than import restrictions. In case import restrictions are imposed without having a protective purpose but in order to save foreign exchange by curtailing consumption, they have to be accompanied by suitable fiscal and monetary measures at home. This leads to the necessity of thorough planning in granting protection. For instance, these considerations should be studied; what particular industries should be protected and to what extent; how to prevent demand from spilling over from the foreign goods that are kept out to alternative domestic projects—for example luxury products; and more generally, how to prevent the diversion of resources from the lines they should follow according to the development plan. The element of surplus labour, which is a valid reason for subsidy, has to be looked into carefully; there may be alternative uses where the relative productivity is different. Likewise, the effects on external economies must be carefully estimated and compared.³

To conclude in Gunnar Myrdal's words, “The interferences are there, and are a necessary result of embarking upon a development

1. Quoted by Gunnar Myrdal, *Op cit.*, p. 2/8.

2. *Ibid.*, p. 279.

3. Gunnar Myrdal, *Ibid.*, p. 281.

policy. The real and practical problem is only how they should most effectively be planned and most wisely carried out."¹

Tariffs and Quantitative Restrictions in relation to Developing Countries.

In order to push its development, an underdeveloped country will normally be bound to restrict imports of consumption goods in order to devote as much as possible of its available foreign exchange to buying capital goods. The necessity to maintain and eventually to raise the standard of living among the people would call for import of certain consumption goods in preference to other consumer goods. Especially the luxury goods would have to be drastically reduced. The tendency will be to produce at home and substitute for imports everything it can produce at the same prices. Thus, the need for a proper import policy, is vital.

From a purely technical point of view, import restrictions assist in creating the demand basis for a new industry. The consequent increase in the internal price of the products sustains the development of new industry. A general flat duty on all imported products which can be produced at home would achieve import savings and encourage the development of particular industries. It would also remove the difference between agricultural and industrial costs. Besides, it would ease exchange situation but would not worsen the terms of trade as devaluation would. It would generally promote industrialisation.

It could also be supplemented with special levies on luxury goods and corresponding internal taxes on home produce so that incomes are redistributed, consumption is directed along the desired channels and imports are considerably reduced. However, such a scheme would not be adopted because (a) no underdeveloped country would leave to market its developmental policy; (b) businessmen do not possess the necessary initiative and responsibility in such a country and (c) increasing pressure will be exerted upon the government to take active participation in development.

The next solution could be fixing regular tariffs fixed at different levels but embodied in semi-permanent legislation. They are more stable than quantitative controls of various types as the latter can be conveniently changed at slight pressure. The greater stability would stimulate direct foreign investment as the foreigners dislike the uncertainty associated with quantitative controls. Moreover, the windfall gains are greater with quantitative controls and are largely appropriated by importers. This would also go against quantitative restrictions.

These are just and ideal considerations. They assume a stability in international trade which is non-existent. Export earnings of developing countries are uncertain and the demands posed by the development process are equally uncertain. As such they will have to rely more upon

1. Gunnar Myrdal, *Opcit.*, p. 281.

direct trade and payments controls as quite regular means of commercial policy.

In practice the quantitative controls lead to more and more rules and develop into a very complex system. The chances of corruption increase and business morale deteriorates. First symptoms of the disease are visible in administration. From there they spread to the entire body politic. Industrialists and businessmen are encouraged to go in for shady deals instead of steady, regular business. The whole atmosphere becomes dirty and quick profits become the watch words. Apparently politics and society are duly affected and the psychological foundation for development planning and its efficient execution is destroyed. The system breeds contempt and heads towards a total collapse.

Keeping in mind above arguments, Gunnar Myrdal suggests that underdeveloped country should impose restrictions by regular means of tariff or for multiple exchange rates. It should avoid quantitative restrictions though they are flexible. However, since it cannot avoid quantitative restrictions, it should simplify and rationalize direct controls and should get them administered with scrupulous honesty.

COMMON MARKET

Q. Explain the rationale of common markets. Examine the need for an Asian Common Market. *Or*

Discuss the economic arguments for European Common Market. Is an Asian Common Market possible and desirable ?

Ans. ECONOMIC INTEGRATION

The Theory of Customs Union.

A Customs Union is an agreement between members of a group of countries to abolish all tariffs levied by each member on imports from the other members, whilst at the same time, establishing a tariff at common rates on imports into the member countries from non-member countries (the so called common external tariff).

A customs union may be very limited, involving one commodity, or it may be complete, encompassing the abolition of all restrictions on the movement of goods and factors and the adoption of common fiscal and monetary policies as well. This complete form of customs union is called an economic union.

The setting up of customs union results in the preferential treatment of goods imported from member countries and therefore discriminates against goods coming from the outside world. Because of this change in the tariff structure, economic relationships within the union change, with the result that consumption and production pattern may alter, the terms of trade may be affected and the rate of growth may change.

Viner and Vauck have contributed most to the customs union theory. Before Viner's contribution in 1950, it had usually been thought a customs union would raise world welfare since it was a step towards a more ideal solution (free trade). However, as Viner pointed out, a customs union may have beneficial as well as detrimental effects since it combines elements of freer trade with elements of increased protection. Thus though the freedom of trade is increased, member states get increased protection in the domestic markets as well as in the market of member states. The net effect of a customs union on welfare depends on whether the beneficial effects outweigh the detrimental effects. The existence of a tariff implies the existence of an

imperfect market. Besides the customs union combines elements of free trade with elements of protection, so it can be dealt with traditional welfare theory which concerns itself with the optimum condition for welfare maximization. Assuming a perfectly competitive world economy, the best situation is free trade, because this will satisfy the Pareto optimum conditions which are defined by the equality of all marginal rates of substitution and transformation for any pair of products and for all individuals.

However, the existence of tariff makes it impossible to achieve such optimum conditions—tariffs distort prices—so a theory is required which will deal with the conditions for improving welfare rather than achieving the best possible (i.e. a constraint maximization problem), such a theory dealing with sub-optimal conditions was developed by Meade, and later restated and generalized by Lipsey and Lancaster—“the theory of the second best.” The second-best theorem can be stated thus—if in an economy all the optimum conditions for welfare maximization are not fulfilled simultaneously, then a change which increases the number of conditions fulfilled does not necessarily increase the welfare of that economy. The effect on welfare of fulfilling one more condition will depend upon the circumstances of each case.

Welfare theory does not permit interpersonal comparisons of utility to be made. Thus, if the formation of a customs union makes one or more persons better off, but also makes one or more persons worse off, then we cannot say whether the net effect on aggregate welfare is good or bad. We can reach a conclusion concerning welfare only if the welfare changes are in the same direction or if it is known whether or not the gainers can compensate the losers fully.

This is extremely relevant to customs union theory, because the formation of a customs union will change the pattern of production, consumption and trade between and within the member countries. Also it is likely that changes will take place in the distribution of income between and within member countries leading to alternation in the distribution of economic welfare. }

(i) Consumption will be affected, the existence of discriminatory tariffs under the customs union will alter the previously existing price structure in such a way as to make imported commodities from the member countries relatively cheaper compared with domestic commodities and with imports coming from the outside world (i.e., relative to the initial pre-custom situation). Because of this relative price structure, consumption will shift towards imports from member countries and away from domestic goods and imports from non-members, so altering the efficiency of consumption and causing welfare changes.

(ii) Production will be affected as well by the relative price changes. Some industries will find that demand for their product has increased due to the elimination of inter-member tariffs and they may be

able to increase output and gain economies of scale, thereby increasing the efficiency of production. On the other hand, inefficient domestic production of certain goods may be stimulated by the existence of a common external tariff higher than the previous tariff level, and this will have detrimental effects on the productive efficiency. As a result changes in the level of welfare and its distribution will take place.

(iii) Trade will be affected in the short run in such a way as to increase the scale of intra-union trade and decrease that between the union and the rest of the world. In the long run, the volume of trade between the union and the rest of the world will probably increase and may even rise faster than if the union had not been formed. This would be the case, if, for example, the formation of the Union led to faster growth rates amongst the member countries leading in turn to a rising demand for import from non-member countries. Increases in intra-union trade may raise the economic welfare of the members but cause a fall in that of non-members. In spite of this, the long run effect may be to raise world welfare to a higher level than that which would have existed had the union not been formed. It will be an extremely complex problem to decide whether the long run gains are great enough to offset the short run effects on world welfare assuming for the sake of argument, that the losses in welfare suffered by the rest of the world are greater than the increases enjoyed by the union members.

These union effects on trade were termed by Viner as "trade creation" and "trade diversion" and are descriptive of the fact that the abolition of tariff barriers between members will stimulate or create intra-union trade (which is generally regarded as being good) whilst at the same time, remove or divert trade from outside countries to member countries (which is generally regarded as being bad). Good or bad on the assumption that trade is desirable (or good) because it increases world income by allowing goods to flow in accordance with the principles of comparative advantage. (i.e., from high to low cost regions). Trade creation and trade diversion have become the fundamental phenomenon associated with the customs union issue and are the main contributions to the problem of assessing the net welfare effects of the union. Not going into the intricacies of welfare economics, we shall assume that if the customs union leads to short run improvements in the efficiency of production and consumption, then welfare will have increased.

Effects on Production.

A customs union may allow member countries to specialise in production according to the principles of comparative advantage and so increase their efficiency. It may also permit the enjoyment of scale economies due to a larger union market being created as a result of tariff removals. According to Viner's analysis of production effects, if the union shifts production from a higher-cost source to lower-cost source, it creates trade, and this constitutes a movement towards freer

trade. On the other hand, if production is shifted in the reverse direction from lower cost to higher cost sources, this constitutes trade diversion and is a movement away from free trade. Given that such shifts may take place, the efficiency with which resources are utilized will be altered and the overall effect may be to increase or decrease productive efficiency. (In general, trade creation will give a more efficient allocation of world resources and trade diversion a less efficient allocation). The meaning of trade creation and trade diversion can be shown very easily by means of a simple numerical example :

Suppose we have three countries : America, France and Germany and their respective costs of production for a certain good are 100, \$80, 90. Suppose America has a tariff of \$40 on imports from France and Germany, who in their turn have tariffs of \$20 on imports. In this situation America will produce the product herself as well as France and Germany, since it would cost more to import from any source. However, let us consider what would happen if America and Germany combine in a customs union with an external tariff of \$30. In this situation, America will import the product from Germany, who will now supply it at a cost of \$90 instead of the previous \$130. No imports will come from France into either America or Germany since the cost of doing this \$110 is higher than the cost of producing in Germany. And America will not produce herself since she can get it on better terms from Germany. This represents a case of trade creation where the place of production is moved to a lower cost source (Germany).

Viner's Analysis.

	Production Costs	Lowest Cost of Imports
U. S. A.	100	120
France	80	110
Germany	90	100

However, if the original tariff imposed by America were \$15 and that imposed by Germany and France were the same (\$20), then America would import the commodity from France at a price of \$95, while France and Germany would produce for themselves and import none. Let America and Germany unite in a customs union with an external tariff of 17. In this case America will import from Germany at a price of \$90 and stop buying from France, since it would now be more costly to do so (\$97). This is an example of trade diversion since production is shifted from a lower cost source (France) to a high cost source (Germany) with a resulting loss in productive efficiency.

If the beneficial effects of trade creation outweigh the detrimental effects of trade diversion, it is usually concluded that productive efficiency will have increased, but we cannot infer from this that welfare will have increased, because some individuals will have lost, and others benefitted, as a result of changes in the location of production. On the other hand, any trade diversion may adversely affect both the union and the outside world, since within the union, production will

shift to relatively high cost sources whilst in the outside world resources will either become unemployed or shift to the production of goods in which the outside world would have a smaller comparative advantage.

Effects on Consumption.

It can be seen that the price of the product fell in A after the formation of the union between America and Germany (from 100 to \$90). Accordingly one would expect that the consumption of the product in America would increase, assuming that the demand curve possesses some elasticity. Even in the second case where trade diversion occurred, imports into America rose and providing that the member country from whom the imports are obtained has a lower production costs than the importing member, some gain will accrue to America. However, as Lipsey shows, Viner implicitly assumed that goods were consumed in some fixed proportion which was invariant with respect to relative prices. But once we abandon this assumption and allow relative price changes to alter consumption patterns then obviously economic welfare will be affected, just as economic welfare is affected by changes in production patterns.

Meade has formulated an analysis of the effects on consumption in a model where production patterns are assumed to be rigid and only consumption and trade can vary. Suppose, for example, our three countries can each only produce one product and that the tariffs imposed by each country on imports from the others are as given in the table below :

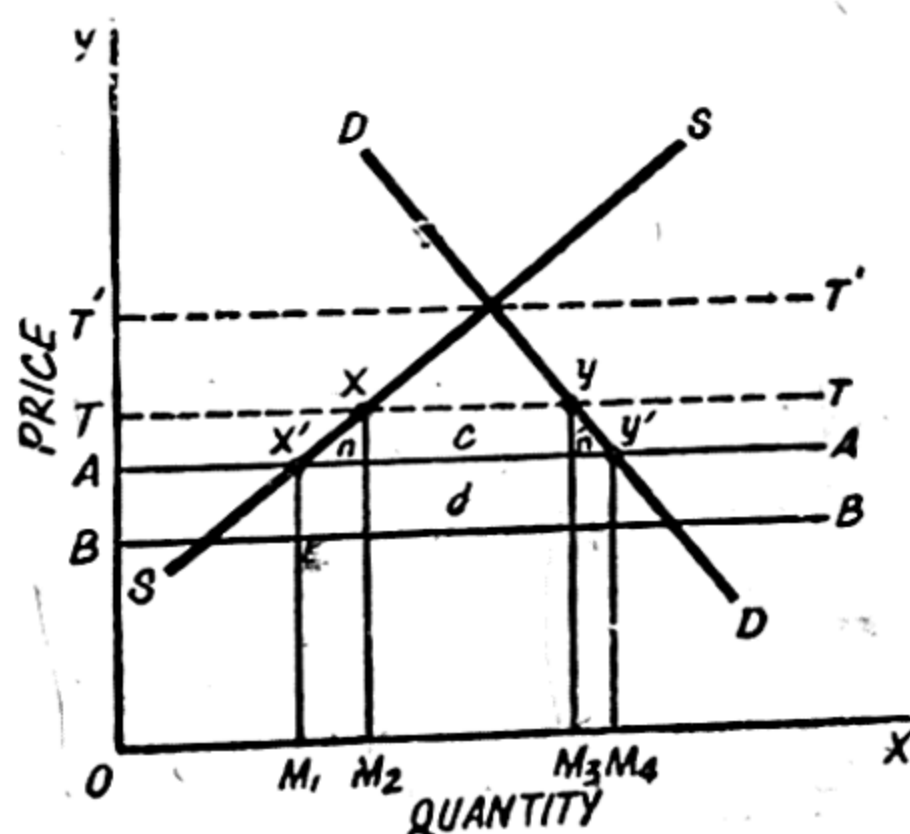
	Product	Tariffs
America	Cars	10%
France	Wine	20%
Germany	Tools	30%

Let America and Germany form a custom union. Then, according to Meade, we can to some extent gauge the potential gain in living standards in these two countries through increased trading by comparing ratios of the marginal utilities of the product. Before the formation of the Union, the ratio of marginal utilities in America between tools and cars was higher than the same ratio in Germany, because America's tariff raised the price of tools by 10 per cent, whereas Germany's tariff raised the price of cars by 30 per cent. The ratio of the marginal utility of tools to the marginal utility of cars is approximately 33 per cent higher in America than in Germany, giving some idea of the gain to be had initially from increased trade. As trade expands, the additional gain declines as the ratios of the marginal utilities in the two countries approach each other. In the union, America removes its tariff on tools and will probably increase consumption of tools and lower consumption of cars and wine. In Germany, imports of cars rise and consumption of tools and wine falls. Thus, to offset the gain from increased intra-union trade, there would be world losses corresponding to the lower level of trade between the union and the third country (France).

According to Meade, the net effect on welfare will depend on the initial tariff structure and the elasticities of demand for the product. The higher the original tariffs of members relative to outside country tariffs, the greater the extent of trade creation and the corresponding consumption gains for members: and the lower will be the losses from trade diversion. Also, the net gain will be greater, the higher the degree of substitutability between member countries products, and the lower the degree of substitutability between products of members and non-members. This would mean that the demand elasticities are high for member's products and low for non-member's products, thus tending to cause a large amount of trade creation but little diversion.

Let us analyse the combination of both effects diagrammatically. Let us see what happens for a single commodity when a union is formed, assuming for the sake of simplicity that all demand and supply curves are linear, that the domestic country faces increasing costs of production whilst the foreign supply curves are infinitely elastic, and that exchange rates are fixed so that prices in foreign currency can be converted into domestic currency. Domestic demand for the product is represented by DD and domestic supply by SS , with foreign supply curves for two countries A and B being AA and BB (A represents a potential union member and B represents the rest of the world).

Now let a tariff of BT be imposed by the home country on imports from A and B . In this situation, imports of $M_2 M_3$ will come from country B with no imports from country A (because A is a relatively high cost producer), and OM_2 being produced domestically. Total consumption is OM_3 and the domestic price is OT ; with the level of economic welfare domestically being represented by the sum of consumer surplus (DYT), producer's surplus (SXT) and tariff revenue ($BT \times M_2 M_3$).



Now suppose the tariff BT is abolished for trade between the domestic country and country A ; then AA becomes the relevant foreign

supply curve since country A is now a relatively cheap source of the product compared with B. Price in the home market falls to OA with $M_1 M_4$ being imported from A and OM_1 being produced domestically. Total consumption of the product is now at higher level, OM_4 , than previously. It can be seen that in forming the union a certain amount of trade creation and diversion has taken place—trade between the members has increased, whereas the trade between the home country and country B has ceased, constituting trade diversion, since B is a low-cost producer relative to A.

The size of trade created is equal to the cut-back in domestic production ($M_1 M_2$) plus the increase in import volume ($M_3 M_4$) whilst the extent of trade diverted is equal to $M_2 M_3$.

Bearing in mind the limitations of Meade's analysis, we can also measure the welfare gains and losses. Due to trade creation, consumer surplus increases from DTY to $DY'A$ (i.e. by $TY Y'A$) whereas producer's surplus falls from SXT to $SX'A$ (i.e. by $TXX'A$) and of course the tariff revenue ($BT \times M_2 M_3$) is lost, part of the loss being offset by increased consumer surplus (area "C") the remaining loss being due to trade diversion from country B to country A (d). The increase in consumer surplus exceeds the loss of revenue "C" and the loss of producer's surplus by an amount equal to the area of triangle "n", plus triangle "n'", the area representing the net welfare gain through trade creation. (The overall welfare effect of the union depends on whether or not the net welfare gain from trade creation exceeds or falls short of the welfare loss from trade diversion (d). On the foregoing analysis it was assumed that the supply curves of external countries were perfectly elastic and as a result, consumer's and producer's surpluses for these sources do not change. However, if external supply curves are less than perfectly elastic, then as trade is diverted from foreign to union sources, the foreign supply price falls and the home country will gain improved terms of trade on any trade with non-member countries which survive the union. One result of this movement in the terms of trade will be to lessen the degree of trade diversion, the help from this increasing, the more the foreign source is exploited. Also, as imports from members expand, the supply price will tend to rise, thus increasing the losses through trade diversion.

However, despite the limitations of our analysis, certain general points can be made concerning the welfare effect of consumption and production shifts:

(i) The higher the initial tariff level, the greater will be the gain from trade creation. In the above diagram a tariff of BT' would increase the area n and n' and lower the area of d.

(ii) The more elastic the demand and supply curves for the home country, the greater will be the gains from trade creation. It can be seen from the diagram that the flatter the curves are, the greater will be the area n & n'.

(iii) The losses from trade diversion will be smaller, the smaller the differences in costs between the partner and foreign sources of supply. Again it can be observed that a lessening of such cost differences will reduce the area (d).

(iv) Trade diversion will be lesser, the lower the elasticity of demand in the union for goods imported from outside the union, and the lower the elasticity of supply of such goods from the outside world. Also, the more inelastic the foreign demand is for union exports, and the more inelastic the supply of foreign exports to union, the greater will be the terms of trade gains for the union.

(v) The lower the common external tariff imposed after the formation of the union on external imports, as compared with the pre-union tariff, the smaller will be the losses from trade diversion because it would be less likely under such circumstances that a union producer will displace an outside producer in supplying the union market.

(vi) The larger is the union, the lower is the possibility of trade diversion and the greater will be the gains from reallocating production. Also, the union is more likely to raise economic welfare, the lower the proportion of pre-union trade with outside countries.

We can also say that trade creation may have beneficial effects on member's trade with the outside world. This would be the case if some foreign products were complementary to imports from partners, or if the member's exports to partners are the substitutes in domestic consumption for foreign goods. In either case, trade with the outside world would increase for such products. Of course the effects could go the other way and this would accentuate the losses from trade diversion.

Which Countries would gain most from forming a Union ?

Before the publication of Viner's book, it had generally been thought that a union between complementary economies (*i.e.* countries with different patterns of production and little overlap in the types of goods produced) was more beneficial than a union between rival economies (*i.e.* economies with similar patterns of production and much overlap in the type of goods produced). Viner, however, argued that the reverse was the case on the ground that a union of rival economies would cause greater trade creation. This argument gave rise to great confusion until it was realized that Viner's definitions were ambiguous. Viner was referring to the range of products produced, whereas modern usage of complementary and rivalry refers to differences in comparative production costs.

Rival (or competitive) economies are one with similar costs ratios between products, and complementary economies are ones with dissimilar cost ratios. Once we define the terms in this way, a union between complementary economies (one with similar products but at differing comparative production costs) will give rise to greater gains than one between rival economies (producing dissimilar products). If trade

creation does occur, then the gains will be greater, the greater the difference in costs of production between the members of the union. One can also say that the more dissimilar the members are to the rest of the world, the more they will gain, because trade diversion will then be less, since members will still have to import such products produced by the outside world, but not in the union (*i.e.* raw materials, etc.). In the light of these observations one would expect that a customs union like the EEC would be highly successful since (a) a high proportion of pre-union trade was with each other; (b) they produce and trade in much the same products; indicating a high degree of rivalry. When one looks at the rate of growth of intra-union trade after the formation of the union, these expectations are borne out. A similar picture is available when one studies E. F. T. A. trade, though the growth of intra-union trade here has not been so great; probably because the members of EFTA are more complementary than those of E. E. C. Some trade diversion will of course, occur even for the E. E. C., especially for certain tropical food-stuffs previously imported from Latin America and for temperate agricultural products coming from America. In E. F. T. A. the degree of trade diversion will be much higher and will cover a broader range of commodities.

So far as underdeveloped countries are concerned, a large proportion of their trade is with industrial economies and it is likely that if such countries formed a union, any domestic manufacturing industry would be heavily protected, and as a result a large amount of trade diversion would take place.

SECONDARY EFFECTS OF INTEGRATION

As a result of the union being formed, competition may become more widespread as national boundaries are flung open and so lead to increases in productive efficiency in addition to the initial production reallocation effects. Thus even if monopolists exist in one country before the Union, they will have to compete with their counter-parts once tariffs between members are removed. Also, by enlarging the market and increasing the speed of information regarding prices etc. throughout the union, other obstacles to competition should be removed (e.g., lack of initiative on the part of businessmen operating in a protected domestic industry). Scitovsky is the major proponent of such views arguing that the major gains in productive efficiency will come from the reorganization of production not so much between countries as within countries. Other economists, however, suggest that a customs union will foster the growth of cartels and monopolies, especially if internal economies of scale are important and the market for the product rather limited.

(ii) \ The formation of a union may speed up the rate of growth of member's economies due to important large scale economies releasing resources for other uses, and also the larger market making investment and expenditure on research and development more attractive and safe. However, recent studies do not show a superior performance of large

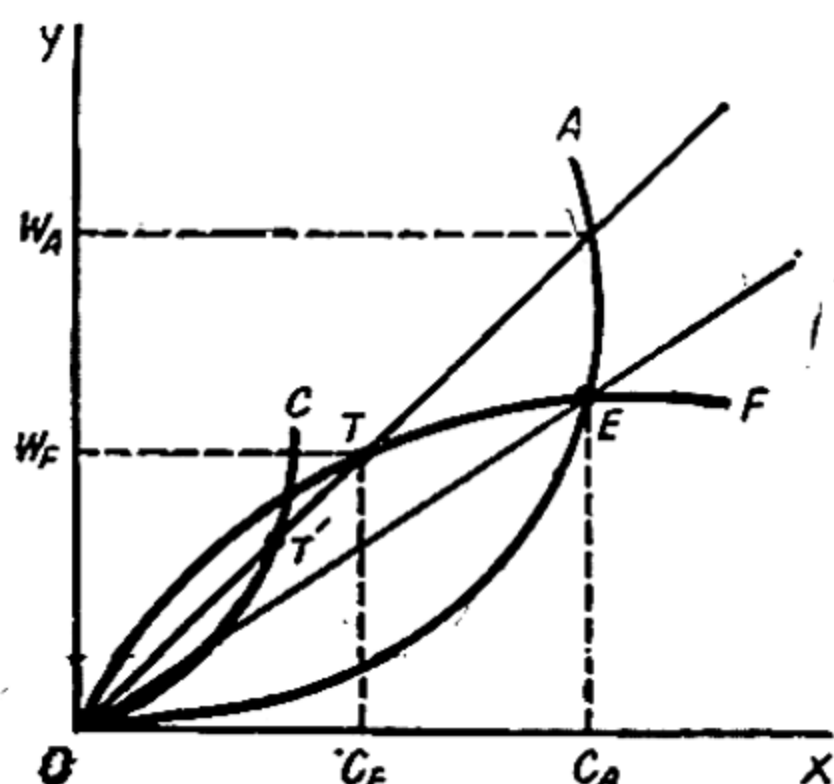
firms so far as innovation goes. Thus, technological advance may not speed up as a result of forming a union. However, if growth does accelerate, this will have beneficial effects on the outside world since rising real incomes within the union will tend to reduce the degree of any trade diversion which occurred in the short run. This offset will, of course, depend on the rate of growth of income within the union and the marginal propensity to import of the union members.

(iii) A union formation may allow firms and industries to exploit even fully large scale economies. However, even with large scale economies, production costs within the union may still be higher than cost outside, and if trade diversion occurs in such industries, then some or all partner countries may suffer a decline in welfare as a result of union formation. Some economists (Balassa) argue strongly that the formation of a union and the resulting enlarged markets will cause substantial scale economies, and that Western European integration will give rise to such external and internal economies. On the other hand Johnson argues that if Britain were to join the E.E.C., only small gains from scale economies would result. Kindleberger argues that European firms, in general, are not too small to be efficient. In fact firms may become too big and so create inefficiency. In addition, firms, limited to a small domestic market, are always able to expand the market by exporting and so grow and achieve any economies available. A union is not required for this, although it may make exporting easier. All we can say regarding external and internal economies is that the evidence for advanced industrial countries is inconclusive and cannot give any great support either way so far as customs union is concerned.

Customs Union and General Equilibrium Theory.

Vanek has contributed most in this field. Let America and France form a customs union, and let "X" represent the rest of the world, with America's exportables being cars, France's exportables being wine. We can represent the preunion trade set up between America and France by means of their offer curves as shown below: OA is America's offer curve and OF France's offer curve, the equilibrium terms of trade being the slope of OE. Now the major step in Vanek's treatment is to construct an excess offer curve for the two countries intending to form the union. This will show the net offer curve of American and France acting together in trade with the rest of the world 'X'. To construct these excess offer curves, consider the varying situation for the union countries at different terms of trade. If the terms of trade are the slope of OE, then trade between France and America is in balance, with no excess supply or demand for other products. Thus, for

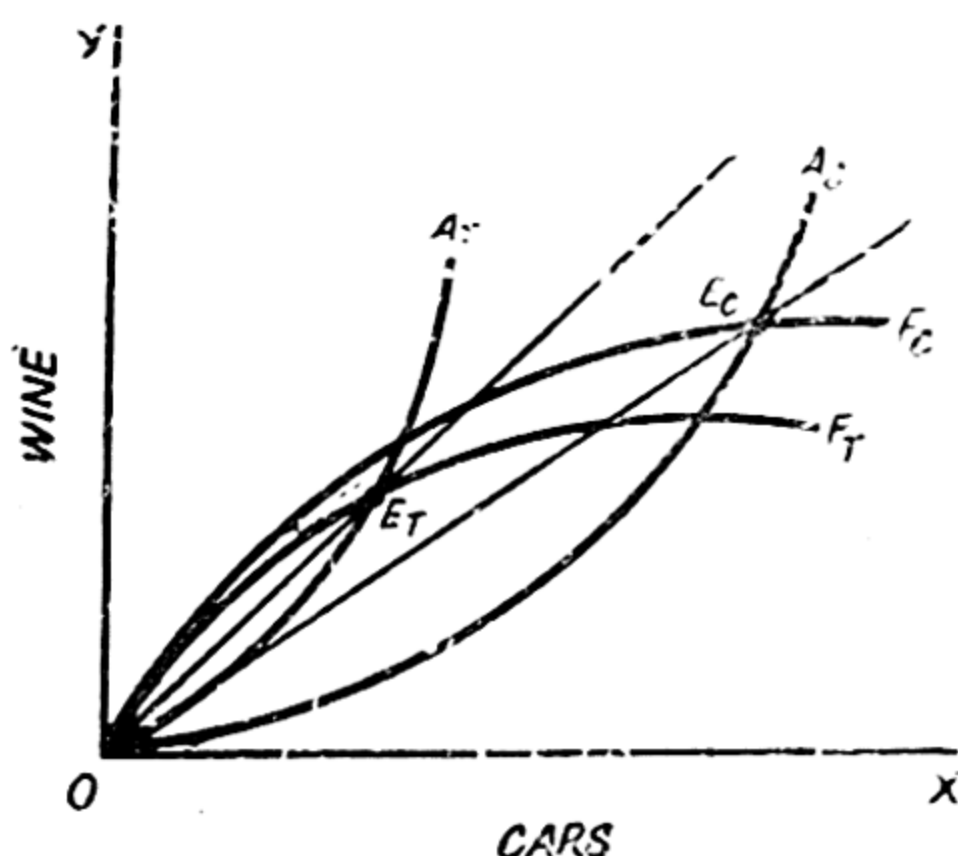
terms of trade line OE, the excess offer curve will be zero and so the



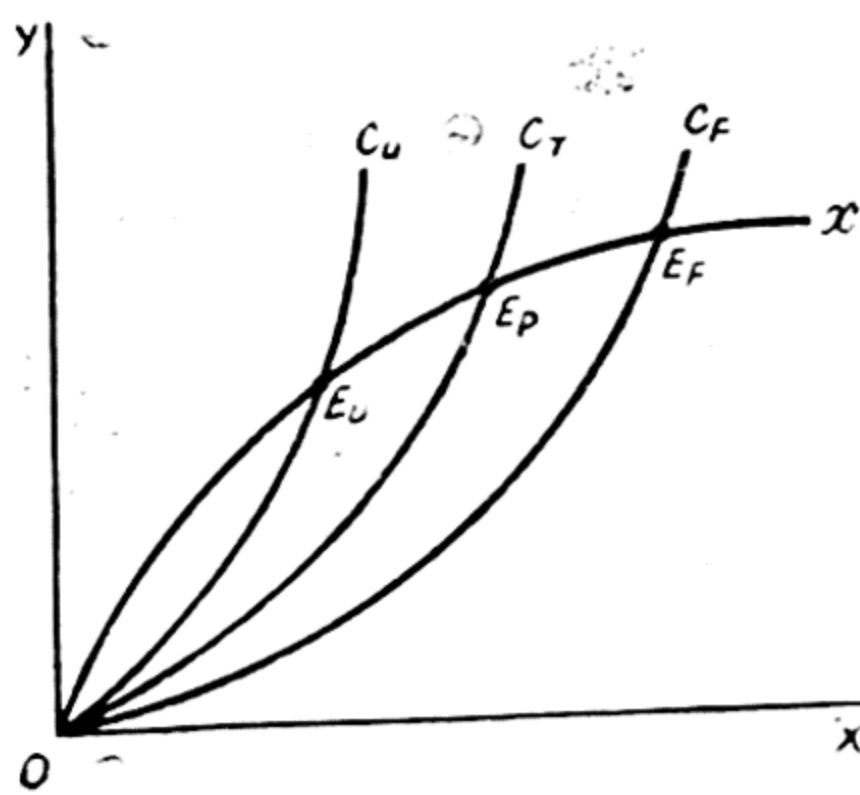
excess offer curve must pass through the origin. If the terms of trade are given by the slope of OT, however, trade between the two countries is not in balance since, at such terms of trade, America is willing to offer OCA cars in exchange for OWA of wine from France, but France is only willing to offer OWF of wine in exchange for OCF of cars. We can say, therefore that in this situation there exists for the two countries together an excess supply of cars given by $C_F C_A$, or to put it in another way, an excess demand for wine, given by $W_F W_A$. This would mean, that at the terms of trade given by the slope of OT, the two countries together would be willing to offer $C_F C_A$ of cars in exchange for $W_F W_A$ of wine. If such an exchange took place with the two countries exporting cars and importing wine, then trade would balance and OT would become equilibrium terms of trade. Thus we can plot one point on our excess offer curve corresponding to terms of trade of the slope of OT, this point having an X coordinate given by the length of $C_F C_A$ and a Y coordinate given by the length of $W_F W_A$. (i.e., point T in the diagram). If we do the same for other terms of trade having values greater than the slope of OE, then we will trace out an excess offer curve OT'C. This offer curve will show how much exports the two countries acting together (i.e., in a customs union free trade area) are willing to offer at different price ratios in exchange for imports from the outside world.

To show the effects of forming a union between France and America, suppose that both countries imposed tariffs on each other's imports and that the extent of these tariffs is given by the shifts of their offer curves to the free trade position after the formation of the union. This is illustrated overleaf where OAC and OFC are the custom union offer curves of the two countries and OAT and OFT are the corresponding offer curves before removal of the tariffs. If America

and France trade only with each other, then the equilibrium terms of



trade before tariff removal would be given by the slope of OE_1 , and after tariff removal, the terms of trade would become the slope of OE_2 . This shift represents an improvement in the terms of trade for America and a deterioration for France. However, given that the two countries will be trading with the outside world the equilibrium terms of trade will be determined by the intersection of the free trade excess offer curve of the two countries and the offer curve of the rest of the world. This is shown below, where OCE is the excess offer curve when tariffs are in force between the two countries and OX is the offer curve of the



rest of the world. E_P is the equilibrium position before the formation of the union. Once the union is formed, trade between France and America is free, but a common tariff is imposed on imports from the rest of the world, and so the excess offer curve corresponding to the free trade positions of France and America (OCE) shifts leftwards to

OCu, the extent of the shift depending on the size of the common external tariff. EU represents therefore the equilibrium position for the world after the formation of the union, between France and America.

In the above situation, the terms of trade for the union have improved in relation to the pre-union position (OEU is steeper than OEP). Within the union, the terms of trade given by the slope of OCF, improve for France and deteriorate for America (OEP is steeper than OEF). It can also be seen from the diagram that the higher the tariff imposed by the union members on outside imports, the more will OCF shift and the greater will be the extent of trade diversion. Although America's terms of trade deteriorate for intra-union trade, she will benefit from trade creation effects, exporting more to France than previously.

It is too simple and too much should not be read into it. For instance, if the union is very small economically, then the offer curves of outside world will be infinitely elastic, with the result that the union cannot alter the terms of trade by imposing a tariff on outside imports. Also, if the union promotes and allows a faster rise in productivity and output, then real incomes will rise, and depending on the propensity to import of the member countries, the demand for imports will rise and so tend to worsen the terms of trade for the union. If trade diversion takes place, however, they will tend to improve the union's terms of trade by reducing the demand for imports from the outside world and also by lowering the supply of exports from the union to the outside world.

Thus, unless we specify the time period, involved and the strength and direction of the forces operating on the terms of trade, we cannot determine for certain in which direction the terms of trade will move as a result of the formation of the union.)

EUROPEAN ECONOMIC COMMUNITY—EUROPEAN COMMON MARKET

(The Treaty of Rome, on signature by Belgium, France, West Germany, Italy, Luxembourg and Netherlands on March 25, 1957 gave birth to the Common Market or the European Economic Community. These six countries have a population only 5 per cent smaller than that of the United States, and a combined national product nearly as large as Russia's. Besides the union is in dynamic stage. It is growing from strength to strength. After the entry of Britain, the Union has become one of the super powers on the world map. The British entry has caused serious problems for India and other developing countries. A discussion of the important development is proper and should proceed with caution.)

After the Second World War, European states shared the mutual concern against aggressive nationalist tendencies and appeared determined to avoid the havoc and destruction caused by the last war. They share.

common civilization and a common realization that mutual conflicts and bickerings have never enhanced their interests. Besides, they could face the super powers only if they united and sank their differences. Their proud heritage and the relative youthfulness of the super powers left for them no alternative but to seek a closer union.

There has been serious dispute about the form and the type of institutions that European co-operation should take. The functionalists, represented by Britain and Scandinavia, held that the minimum of new political institutions should be set up to carry out whatever joint action is necessary; many functions could be adequately carried out by inter-governmental co-operation. The federalists, led by Frenchmen such as Monnet and MSchuman, regarded the setting up of supra national institutions as an essential requirement of economic and political integration. They would prefer more closer union and a greater say in world political affairs.

European unity has made astonishingly rapid progress since the end of the Second World War. The first concrete step towards European Cooperation in the economic sphere was taken in 1948 with the setting up of the Organization for European Economic Cooperation (OEEC) whose functions were to distribute Marshal Aid funds, to co-ordinate investment programmes and to resuscitate intra-European trade. In the previous year a customs union between Belgium, the Netherlands and Luxumberg—Benelux - was formed; in the years many steps towards the economic integration of these countries were formed.

Within the limited sphere of reviving trade between the European countries after the war, the OEEC was very successful. Its first step was a programme of trade liberalisation, but after a certain stage it was found that trade could not be expanded further without setting up credit facilities and making payments multilateral. Both these functions were performed by the European Payments Union set up in 1950. By 1956 intra-European trade had more than doubled, but further expansion was slow after this. Hence in 1960 the OEEC was replaced by Organization for Economic Cooperation and Development with wider membership and aims. The aims of the new organization, which included the United States and Canada, were to achieve the highest possible rate of economic growth for members, and to contribute to the expansion of world economy and world trade.

Meanwhile, efforts persisted for closer political union. The experiment with the Council of Europe in 1949 did not satisfy the expectations aroused. As a result the European Coal and Steel Community was set up by the Paris Treaty of 1951 with France, Germany, Italy and the three Benelux countries as members. The primary object of the community was to set up common markets in coal, iron ore, scrap and steel and by early 1953 most of them were in being. Britain refused to join it. Meanwhile other plans for Defence

and Political Communities continued to be framed, but the objective of achieving closer union failed to materialize.

The European or the federalists or the demanders of closer political union decided that their next move should be in the economic and not in political field and that it should take the form of a supra-national institution. The six discussed a plan for a Common Market and for nuclear cooperation at the Messina Conference of 1955 and by 1957 the treaties establishing the European Economic Community were signed; they came into force on Jan 1, 1958.

The ultimate object of all European organizations including the EEC is to achieve political union and through commonly accepted methods like the removal of market barriers, the formulation of a common policy and the formation of the habit of looking at problems from an international point of view. The European Economic Committee has the widest scope: it sets out, first, to establish a customs union with no internal barriers to trade and a common external tariff and commercial policy, and secondly, to abolish all obstacles to the movement of people and capital within the community. Since agriculture and transport are fields in which each external government plays an important part, common agricultural and transport policies—which will even out, for example, differences in the rates of government subsidies—were to be established, and other economic and social policies harmonized.

The executive organ of the EEC is the E.E.C. Commission. It consists of nine members chosen for their "general competence and independence". The members of the E.E.C. Commission are appointed by the national governments by common agreement and their term of office is for four years but may be renewed. The Commission is supra-national, its members are expressly enjoined not to "seek or accept instructions from any government or other body." The decisions of the Commission are taken by a simple vote, and its responsibilities include the direction and administration of all the provisions of the Treaty. Generally the recommendations of the Commission carry great weight. The Commission also acts as the official spokesman and the primary representative of the community, both to outside governments and institutions and to the members of the governments themselves. President Hallstien has frequently described the various roles of the Commission as those of initiator of policies, of honest broker (between the members of the community) and the custodian of the Rome Treaty.

The European Common Market is being set up over a transitional period of 12 years divided into three stages of 4 years each, the types of action required and the institutional means of taking decisions during each stage being specified. In the first stage, nearly all important decisions had to be unanimous, but majority voting is progressively introduced in the later stages and has been the general rule since 1966 when the third stage starts. The Rome Treaty made provisions for the transitional periods to be prolonged to 15 years, though the progress has been faster.

Thus by 1967 internal duties and agricultural duties were to be completely abolished. Thus all custom barriers have completely disappeared. The rapid progress has acted as a stimulus to visible trade, and demand for consumer goods has risen enormously.

Intra-Community trade between 1957-1966 has risen by 240 per cent, almost four times as great as the expansion of world trade. Total industrial production has increased by more than half and workers can move about in the EEC without hindrance. They are assured of benefit from improved social security provisions on equal terms in all six countries.

In many respects, the freeing of trade in industrial goods was a relatively simple task. It is in agriculture that the Community has been faced with some of its most serious problems. In everyone of the six, farmers are subsidized and agricultural prices are controlled. But the systems of farm support differ so much that if one common market for agricultural products is established, the farmers in one country will benefit at the expense of those in others. Consumers will also be differently affected. In general, the Dutch and the French have the most efficient system of agriculture and the Belgians and the Germans, where the proportion of small farms is high, have the least efficient.

The general lines of agricultural policy have been agreed upon, gradually one unified market will be established within the Community. Prices will continue to be supported, but there will be one common support price or "intervention" price at which the member governments will buy from their farmers. This, together with the abolition of all barriers to trade in agricultural commodities, such as quota restrictions and import duties, will mean that there will be uniform farm prices for agricultural commodities within the Community, apart from differences in transport costs and so on. As regards trade with the rest of the world all existing quotas and custom duties are to be removed. Instead imports will be subject to a levy, equal to the difference between the world price for the commodity and the "threshold price" (*i.e.* the minimum import price fixed by the Council) in the importing country.

Progress in implementing the agricultural policy has been very slow. Fixing the price of important products, especially cereals, met great difficulties. Germans did not want to yield, the British were undecided and French largely stood to benefit, but the combined pressure of France and the United States forced Germany to accept the uniform prices for wheat, barley, maize, rye (effective from 1967-68). These domestic prices were above world prices.

Once the customs union is set up, the degree of preference given to producers within the union will depend on the level of the common external tariff (*i.e.* C. E. T.). The G.A.T.T. regulates that the C.E.T. should not have a more protective effect than the national tariffs which it replaces. The Community contends that it met this requirement by

adopting the general principle that the level of tariffs should be the arithmetic average (unweighted) of the national tariffs as on January 1, 1957. However, the 25 per cent reduction in the German tariffs by 1957 and the 10 per cent reduction in the Italian tariffs were not taken into account. As such, the Common External Tariff on some commodities was higher than the average of the national tariffs actually enforced in 1957.

In any case, the arithmetic average principle was not universally applied. Seven lists of exceptions were set out in an Appendix to the Rome Treaty. Very broadly, the CET applies very low rates on primary products and raw materials, which rarely exceed 3 per cent and are often nil; on processed raw materials and semi-manufactured commodities the rates generally go up to 10 to 15 per cent or so; on foodstuffs and beverages and on manufactures the rates are considerably higher but rarely go above 25 per cent. Important exceptions are carpets of wool, and silk, motor cycles and motor vehicles. Even if all the CET rates were unweighted arithmetic averages of the national tariff, it might still be more restrictive than the national tariffs it replaces. The height of a tariff is only one of the factors determining its restrictiveness; others, which may be even more important, are the composition of trade, and the responsiveness of supply and demand to price. A high tariff on cars levied by India may restrict actual imports far less than a low tariff levied by Germany, since cars made at home are much less competitive with imported cars in India than in Germany. For this reason, some cities of the Common Market argued that the CET should have been arrived at by weighting the national tariffs with the volume of trade of each country; for instance, the low Benelux tariffs should have been given a larger weight, in proportion to their trade. But it has been calculated that if either in 1958 or 1959 pattern of trade had been used for weighting, the resulting tariff would on average have been higher than a tariff which was a simple arithmetic average. It is indeed, generally agreed that the CET is by most measures lower than the average of the previous national tariffs of the six, and certainly of the non-preferential U.K. tariff and perhaps the U.S. tariff also.

However, the problem of trade diversion remains. If the national tariffs on cars had been, let us say, 30 per cent in all the six, while the CET was 20 per cent, the exports of other countries to the six might still fall because German cars, for example, would get a new preference of 20 per cent in the rest of the Community over the imports from outside. The extent to which trade is actually diverted will depend on whether or not there are alternative sources of supply within the community for a particular export. But supporters of the Community argue that the trade diversion brought about by the CET is offset, or more than offset, by the growth in the demand for imports resulting from the growth in incomes, which in its turn is a consequence of the creation of the Common Market. But whether, and in what way, the economic

growth of the six is related to economic integration is far from chaos. The trade diversion aspect of the customs union would seem to be better established than the income effect."

The earliest study made by Dr. P.J. Verdoorn, estimated the effects of a customs union among the six, the U.K. and the three Scandinavian countries, on the basis of the 1952 patterns of trade. The formation of the union, according to this estimate, would result in a fall of 600 million in the export of semi-manufactured and finished goods from the rest of the world to the union or 6 per cent of third country exports to the union, the chief country to suffer would be the U.S.

Prof. Tinbergen has measured the "rate of discrimination" for a large number of developing countries, this being defined as the difference between the import duty on a particular commodity levied in third countries and the average duty imposed on all imports. Then, if some product is imported into the Community only other parts of it, the average duty will be zero, since no duties will ultimately be levied on intracommunity trade. In contrast, if all imports come from third countries, the average duty will equal the CET and there will be no discrimination. For any third country, the overall rate of discrimination will depend on the extent to which its exports go to the Community, the height of CET on these exports and competition from within the Community. This formula was applied to the 1955 pattern of exports, the rate of discrimination in general was very low; it was less than 2 per cent for nearly all the 31 countries studied, and less than 1 per cent for 20 of them. Only for Cuba and the Dominican Republic, with their heavy dependence on a very narrow range of exports, was the rate about 2 per cent. But Prof. Tinbergen's formula understates the extent of discrimination in at least on very important case. These commodities on which the national tariffs in 1955 were so high as to keep out imports or in which there were quota restrictions, would be given a low weightage. For example, the rate of discrimination against India would rise significantly if cotton textiles were included, and were given a weightage equal to their import potential, not actual imports.

Opinions differ about how much the EEC affect U.S. trade. Some of these find that CET is higher than the national tariff. Some concentrate on the income effect and find that it will not be important because the growth of income will be of an import-replacing character. A recent study finds that this height of US and CET are broadly similar, though the CET is much higher on food products.

It is almost certain that some trade diversion will result because of the formation of the customs union. However, it is not certain whether this will be offset by growth in income leading to increased imports into the Community. Besides the effects will differ from country to country. But some general features of the CET may be noted. Firstly, the duties on primary commodities, which do not compete with domestic

commodities, tend to be nil or very low. Secondly, the duties are raised at each stage of manufacture—raw materials processed or semi-finished materials and manufactures - in order to protect the domestic processing and manufacturing industries.

INTERNATIONAL ECONOMIC INTEGRATION

The term economic integration became popular after the Second World War. Previous to the First World War the term integration had a static significance. It stood for balance and assumed the existence of rich and dynamic nations on the one hand and poor and stagnating nations on the other hand. After the Second World War, political situation has changed. Along with it "integration" has achieved a new dynamic interpretation. Its essence lies in a violent and radical breaking down of cultural isolation and in the rising tide of demands from the formerly passive and silent masses in the backward regions for greater equality of economic opportunity and fuller participation in our modern civilization. The term thus implies a goal of social change and more specifically, of the internal and mutual adjustment of national communities rapidly brought into much closer interdependence.

Economic integration, according to Gunnar Myrdal, is the realization of old western ideal of equality of opportunity. The essential element of this ideal, is the loosening of social rigidities which prevent individuals from choosing freely the conditions of their work and life. The economy is not integrated unless all avenues are open to everybody and the remunerations paid for productive services are equal, regardless of racial, social and cultural differences.¹ Thus, he makes the point that, economic integration is not only an economic problem, but also a problem of political science, sociology and social psychology. The gradual achievement of equality of opportunity assumes the emergence of a Community with ever freer social mobility, based on a fuller realization of the norms of equality and liberty. In this Community there must be a growing social cohesion and practical solidarity.

The classical theory of international trade assumed that all national economies were perfectly integrated domestically as perfect markets. (An economy would be fully integrated within the prices of identical goods and services everywhere tended to become the same, labour of a given kind commanded the same wage, there was one market for capital with a single rate of interest at comparable level of risks, and when the rent for the same kind of land had been equalized). It also assumed the immobility of factors of production internationally. Equalization of factor prices, as was possible, was supposed to come about through the international specialisation and division of labour made possible by trade, which was to achieve this purpose by equalising the prices of goods everywhere in the world, within the limits set by transport costs. The practical conclusion of the theory was therefore

1. Gunnar Myrdal, *An International Economy* (New York, Harper and Row 1963, p. 11).

the desirability of free trade. As between developed and underdeveloped countries, international trade does not equalize factor prices but rather tend to set up a cumulative process away from equilibrium. The political development has brought to the forefront the very large and growing disparities and economic development of underdeveloped countries has been recognized as the main goal of international economic integration.

Thus international economic integration, is like national integration, a much deeper and complex problem. It involves problem of social cohesion and practical international solidarity, and the building up of a machinery for accomplishing inter-governmental agreements and large scale political settlements, as halfway house to the common decision on economic policy that may be out of reach for present age.

According to Tinbergen, "Economic integration of a number of countries consists of the centralisation, at a supra-national level, of a number of instruments of economic policy, preferably of these instruments showing considerable external effects [conflicting or supporting]." Centralisation may take different forms—consultation, coordination and complete unification. Several tasks and institutions are left to the control of national governments. These must maintain "spending equilibrium at a high level of employment." Through financial policy, total internal demand will be kept at the desired level and its composition be made optimum. Wages and exchange rates may be used to adjust the general price level of the country to its competitive strength, and hence, to regulate foreign demand. Besides these, temporary subsidies, specific taxes or temporary import duties may be necessary to support industries or regions whose competitive position falls short of the requirements. In the short run, quantitative regulations may be needed.

Besides, Tinbergen notes certain non-monetary instruments. These are negative as well as positive. Negative integration involves the gradual elimination of quantitative restrictions and import duties. Positive integration involves coordinating the use of some instruments, like indirect taxes, in order to avoid a falsification of the price formation and the ensuing decision of labour. Monetary integration should involve the introduction of a world currency, but this might demand political unity as a precondition. Monetary integration involves several measures. Ultimately agencies of international integration are discussed by Tinbergen.

The industrially advanced countries have achieved greater equality of opportunity and are expecting still greater level of equality of opportunity and higher level of satisfaction. Both progress in production integration have acted upon each other. The advanced countries have witnessed three death and life struggles and are still far away from normalcy. Economic disintegration emerges naturally because of the mutual suspicions and tensions of brother states.

The more a nation integrates, the more it caters to the interests of its citizens, the further it gets from international integration taking into account inequitable distribution of wealth between countries. Besides, several policies directed to achieve national economic stability and equality, have an inherent tendency to cause international disintegration. Thus the more the national states are strengthened, the greater becomes the disparity between these brother states.

Theoretically we cannot eliminate but resolve the contradiction between nation states and international economic integration by greater cooperation and coordinating the national policies in the service of commonly felt interests. As the international community is yet to emerge significantly and they are growing stronger and stronger, all attempts to achieve the international goal meet resistance. The trend has been and still is, in the nature of a continuous retreat to economic nationalism.

Gunnar Myrdal verifies the above conclusion with reference to labour and capital movements. Mostly states have virtually sealed the boundaries of their national labour markets against any intruders. The international capital market has ceased to function, except for the reinvestment of profits or for direct new investments in the countries with puppet governments. Government credits and the operations of the International Bank have hardly become a substitute for the defunct private capital market of earlier times. These trends continue and tend to intensify.

International trade has fallen in relation to production and income. This has happened because of the restrictions placed upon imports to achieve internal economic stability. The trend has been towards an intensification in the efforts to achieve greater degree of currency convertibility and to abolish the quantitative restrictions that are forced upon countries because of foreign exchange considerations. These have become causes of the frustration and dislocation of foreign trade. Looked at from this point of view, lack of convertibility becomes one of the factors inhibiting international economic integration.

The much advertised policy towards West-European economic integration failed to realize its goals because it evaded the integration problems the deeper level of factor movements and never forced the issue of equality of people in different nations. Besides, no effective attempt was made to establish the basis of international solidarity among people.

Thus the problem of the tremendous and growing disparities in factor proportions, factor prices and, therefore, living standards between the industrially advanced countries and the underdeveloped ones—are the major problems of international integration. These arise mainly because the nation states are not prepared to accept the degree of international human solidarity which would make possible progress towards international economic integration. The paradox, however,

is that while human solidarity has been growing in nation states, it has almost implied a shrinking of international solidarity.

Much hopeful view is taken by Tinbergen in his book "International Economic Integration." He suggests that agencies should be created according to the instruments of economic policy rather than according to the aims of that policy. For instance there should be an agency for supervising tariff or exchange rates, since these are instruments. But it would not be correct to have an agency to deal with employment policy, as it is a target. Agencies are general when they deal with economies as a whole. The following general agencies are needed for :

- (i) the supervision and reduction of trade restrictions,
- (ii) the regulation of raw material markets,
- (iii) the supervision of spending equilibrium and employment policy,
- (iv) the supply of capital for development.
- (v) the transfer of knowledge and education assistance,
- (vi) the supervision of the convertibility of currencies,
- (vii) the regulation of migration.

In principle, the United Nations has created agencies for each of the main tasks ; but these have encountered various difficulties.

1. The Supervision and Reduction of Trade Restrictions.

The United Nations charter contemplated the formation of "International Trade Organisation" (I. T. O.) for achieving these ends. However the agency never came into existence as the United States showed its reluctance to accept the amended charter. G. A. T. T. has taken up the task of reducing trading restrictions. Its success has been very limited because (i) many countries are unwilling to move in the direction of free trade ; (ii) the technique adopted to negotiate reduction in tariffs is extremely complicated. The real basic reason has been as pointed out by Myrdal, the tendency to achieve internal stability at the cost of internal economic integration. Certain tariffs have been felt vital for country's economy and the countries concerned have adopted a partisan approach on the interpretation of 'vital'. Europeans have moved closer and benefitted, but unless the developing countries increase the export of goods in which they have cost advantage, we are unlikely to progress towards international integration. These would require lowering of the Common External Tariff by the E.E.C. and liberalisation of tariff by other industrially developed countries.

2. The Regulation of Raw Material Markets.

This is entrusted, at the world level, to the Food and Agriculture Organisation (F. A. O.) for agricultural products and the Committee for International Commodity Trade of the United Nations for mining

products. Besides there are organisations at the regional level and the bilateral's multilateral agreements between countries for specific raw materials. Agreements have not been signed for many other commodities because in periods of rising prices, exporting countries feel less interested while in periods of falling prices, importing countries are not interested. Thus the basic short sightedness of nations have resisted the formation of agreements. Unless this shortsightedness and the desire to put national interest above other interests is reduced, we are unlikely to progress much further. Meanwhile attempts can be made to find other solutions.

3. The Supervision of the Convertibility of Currencies.

This has been entrusted to the International Monetary Fund. Mainly the Fund provides short term credits to member countries to overcome temporary shortage in foreign currencies. There is controversy whether these are adequate. Besides the Fund cannot provide long term credits, it can only recommend devaluation or revaluation as the situation demands. The best international system requires the creation of a really supra-national central bank with its own paper which may serve as reserve material for national central banks. Similarly the most desirable volume of liquidities can only be the outcome of a planned approach, taking the most desirable development of production, prices and payment habits as its elements.

4. The Supervision of Spending Equilibrium and Employment Prices.

These policies are largely left to national governments, but since these are likely to have repercussions on other countries of the world, co-ordination and consultation is required. At the world level no such agency exists. At the regional level the EEC, OECD, OEEC exist and have succeeded in securing greater degree of co operation and consultation. The search for international instrument should continue because the stakes are vital.

5. The Task of Supplying Capital to the Developing Countries.

There are several agencies like the IBRD, IFC (International Finance Co-operation) and the IDA (International Development Association) at the international level to satisfy these needs. At the regional level, several agencies like the EEC's, Development Bank, Colombo Plan and the Alliance for Progress, satisfy this need. However, the scope for further agencies is greater and greater amount of assistance is required by the existing agencies.

6. The Transmission of Knowledge and education assistance.

Various specialised agencies like FAO, WHO, IMF, ILO, IBRD, etc. exist to perform specialised functions of technical knowledge U.N.E.S.C.O. has been doing a good job in the field of education. The progress in this field is quite satisfactory.

7. The Regulation of Migration.

The international agency exists for this purpose, but greater international cooperation is required. Perhaps the family

planning measures will have to be intensified. Advance nations will have to adopt a liberal policy.

Thus it appears that an important start has been made. The existing international agencies are the nuclei of cooperation around which the agencies needed for future must crystalize. If they have not been adequately successful, the fault lies with the governments which are not prepared to use them in the appropriate way. In most international negotiations it is usually the short term or direct national interests which are taken as a criterion rather than the long term and indirect interests—or international interests. Thus the basic malady is the existence of national governments itself. Two suggestions are made by Tinbergen to seek a way out. Firstly, the individual governments could take broad minded individual initiative like the Marshall Plan, Colombo Plan and Schuman Plan. Secondly Political parties and other adhoc organizations could initiate a drive to educate public opinion. Both should base themselves, at least, partly on the scientific analysis of problems (as done by Tinbergen). His analysis will help one to judge which instruments of economic policy are most in need of centralisation.

Tinbergen concludes, "Our analysis.....has confirmed the desirability of a reduction in quantitative restrictions and its import duties, a positive integration of production, a certain unification of indirect taxes, convertibility of currencies, and an international policy of development. It has also confirmed that decentralisation seems desirable for functions of a more local or national character. In addition to all this, the further conclusion has been reached that an essential element of integration will also have to be a higher degree of centralisation in financial policy. The latter conclusion seems to be in accordance...(that) with more centralisation in financial policy many other instruments of economic policy can be left decentralized."¹

Selected Readings

1. Jacob Viner : The Customs Union Issue.
2. Tibor Scitovsky : Economic Theory and Western European Integration.
3. James E. Meade : Problems of Economic Union.
4. Jan Tinbergen : International Economic Integration.
5. Charles P. Kindleberger : International Economy.

1. Jan Tinbergen, *International Economic Integration* (Amsterdam, Elsevier Publishing Company, 1965, pp. 98-106).

INTERNATIONAL MONETARY FUND

Q. Examine the utility of the objectives of I. M. F. for the underdeveloped world, evaluate its contribution in relation to its objectives.

Or

Evaluate the role of special drawing rights in improving international liquidity.

Or

Evaluate the work of International Monetary Fund in maintaining the international liquidity.

Ans. The International Monetary Fund.

The United Nations Charter in its preamble expresses the desire of mankind to save itself from the "scourage of war" which has engulfed the world twice. To this end, it seeks to remove economic causes of war and established the IMF and IBRD to achieve a solution to the problem of disequilibrium in the balance of payments and to help in the multi-convertibilities of currencies. Broadly the Fund provides short-term capital to enable member States to meet any temporary difficulty in the balance of payments.

The Articles of Agreement of the Fund were formulated at the United Nations Monetary and Financial Conference held at Bretton Woods in the United States of America in July 1944. The Fund came into existence in December 1945, when 29 countries signed the Articles of the Agreement. The first meeting was held in March 1946 and the Fund announced its readiness to commence exchange transactions in March 1947.

The purposes of the Fund as set forth in the Articles of Agreement are as follows :—

(a) To promote international monetary co-operation through a permanent institution which provides the machinery for consultation or collaboration on international monetary problems ;

(b) to facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income of the member countries ;

(c) to promote exchange stability and to avoid competitive exchange depreciation ;

(d) to provide for multilateral convertibility of currencies and to remove all exchange controls and restrictions ;

(e) to help members with funds to correct maladjustments in their balance of payments.

The Fund achieves these objectives by (i) holding continuous meeting of its Board of Directors where full discussion of monetary and exchange matters may be conducted ; (ii) by furnishing upon request, expert technicians to advise and assist members in working out their financial and monetary problems and (iii) by making its foreign exchange resources available, under proper safeguards, to its members to meet short-term current balance of payments difficulties.

The Fund reports to the Economic and Social Council of the United Nations but is separate in staff, finances and membership. Thus in 1966 it included the Federal Republic of Germany, but excluded the whole communist world except Yugoslavia. Russia was involved in the original negotiations, and Poland and Czechoslovakia became members but subsequently withdrew in (1950 and 1954 respectively) after continuous friction. Cuba withdrew in 1964 though Romania made enquiries about possible membership. Thus, the membership is open to any independent State which can satisfy the IMF that it can fulfil its obligations under the articles.

Formally, I.M.F. member countries must avoid exchange restrictions on current transactions and maintain a stable exchange rate. They are also required to provide financial information. The communist and other countries do not like these provisions as they amount to incursions on their financial sovereignty. The I.M.F. can also expel and re-admit the member-States.

The I.M.F. is owned and controlled by national governments, though central banks participate closely in the work of the I.M.F. and many countries appoint the governor of their central bank as their "governor for the Fund", otherwise the governor for the Fund is usually the minister of finance. The governors, one for each country, are the ultimate controlling body of the Fund. They wield votes weighted in relation to quotas, on a formula slightly biased in favour of the smaller members. Certain basic decisions are reserved to the governors. These include a general revision of quotas, which has to be approved by a four-fifths majority of the total voting power ; a rise in the world price of gold (a uniform proportionate change in Par Values' in Fund Parlance), which has to be approved by every member having more than 10 percent of the total voting power, effectively giving a veto to the United States and Britain ; and a change in the Articles of Agreement—of which certain changes affecting the particular concerns of individual members need to be approved unanimously. The articles of the Fund probably contain the most elaborate provisions on voting of all

international charters. A number of additional provisions for weighted voting, mostly requiring a majority of 85 percent, were proposed under the amendments presented jointly with the scheme for special drawing right in 1968.

The quotas determine countries, borrowing rights and their primary lending commitments. Nominally, transactions through the Fund comprise not borrowing or lending but an exchange of currencies through purchase and repurchase. The quotas are partly paid up in gold and partly in member's own currencies. The gold portion is normally 25 percent, though for new members it can be smaller if reserves are especially low. The subscription in domestic currency is paid in the form of special non-interest bearing notes. So countries normally start off with the Fund holding their currency to the extent of 75 percent of their quota. A country draws other currencies from the Fund by 'purchasing' the foreign currencies in exchange for a further in-payment of its own currency. These drawings are granted automatically in that portion of the quota—normally the first 25 percent taking the Fund's holding of the currency to no more than its quota. For the country will then have drawn other currencies from the Fund only to the extent of its own gold in payment. The Fund encourages countries to regard this "gold trauche" as part of their reserves, though drawing within this trauche still have to be repaid, and are not to be used to build up the borrower's gold or foreign exchange holdings.

On the next 25 percent of the quota (i.e., taking the Fund's holding of currency to 125 percent of quota and comprising the first credit trauche) the Fund taking a 'liberal' view, satisfying itself only that the country itself is making reasonable efforts to deal with its payments problem. Drawings beyond this meet a rising degree of scrutiny requiring "substantial justification", the normal limit is drawings that take the Fund's holdings of the currency to 200 percent of quota (i.e., a total drawing of 125 percent of quota or the quota plus and the gold trauche). Earlier the limit to drawings was 25 percent of the quota a year, but the policy was liberalized and Britain's holdings in 1964-65 took the Fund's holdings to very nearly 200 percent of its quota. Special provisions have been made for the 200 percent link itself to be breached by primary producing countries to compensate special fluctuations in their export receipts.

The I.M.F. articles themselves specify no time limit for drawings, but by the decision of the Board in 1952, it requires all repayments to be completed in three or five years. Drawings made under "stand by agreements" are repayable in three years. These give countries assurance of a credit line in exchange for a standing charge of $\frac{1}{4}$ percent a year. Charges on actual drawings are usually payable in gold metal, but 'debtor' country may pay in its own currency if reserves are below half its quota. These are service charges and these differ according to varying amounts. Similarly repayments of Fund credits—technically "repurchases" of the country's own currency—can be made either in

gold or in eligible currency. The currency must be convertible and the Fund's holdings of the said currency must be less than 75 percent. In other words, the 'eligible' currency must be the currency of a Fund 'creditor' and not a debtor. A country establishes an effective creditor position in the Fund as these drawings of its currency by other members reduce Fund's holdings of the currency below 75 percent of quota.

In the first 10 years, 92 percent of the drawings were in the U. S. dollars. These drawings reduced the Fund's holdings of dollars in 1957 to 28 percent of the United State's quota, giving America a gold trauche position in the Fund of nearly \$2000 million. However, by 1963 Fund's holdings of dollars had been increased to 75 percent which meant that U. S. dollars were no longer acceptable for other countries' 'repurchases'. Upto 1966, the U. S. A. financed around 10 percent of its liquidity deficit and the run down of its creditor position amounted to '1,800 million, still she remained within her ordinary gold trauche.

In case the Fund requires to mobilize special support for one currency, it can borrow individual currencies, can buy it for gold and can authorize members to impose temporary discriminatory payments restrictions against the chronic creditor. The first loan of currency occurred in 1961. By an agreement of 1962 (and renewed in 1966) the member countries of the Group of Ten stand ready to provide special credits to the Fund in their own currency, provided they collectively do so at first. These credits are separate from the Fund's general resources, and are designed for a specific purpose ; to forestall or cope with an impairment of the international monetary system. They are reserved to meet the drawings of the members of the Group of Ten itself. Once established as a watch dog body, the Group of Ten with its direct representation of working officials of the member governments and no international staff, came to regard itself as a responsible body for major policy innovations and decisions on international monetary affairs generally ; which caused the inevitable frictions with the I. M. F. itself.

The negotiation of these credits marked an important extension of the purposes for which Funds resources were originally designed. Earlier the Fund's resources could not be used to finance a "large or sustained" outflow of capital. However, later declared that a request from a country facing an outflow of capital would be treated by the Fund 'in accordance with its accepted principles, i.e., that appropriate measures were being taken to restore payments equilibrium."

The size of the initial Fund quotas was determined by a complex formula. In the negotiations, each country stressed the quantity that suited it. A member of the French delegation, Prof. R. Mosse, subsequently wrote :

"The Chinese and the Indians would have liked a large weight for population. For the British, the figures on foreign trade were the only true important ones. The Americans were more interested in national

income. The French recommended a formula giving strong weight to population of overseas territories, and to gold holdings. With respect to the Soviets, it was generally admitted that any advantageous formula had to give weight to a co-efficient K, representing their sacrifices and heroism. In the end, quotas were established more or less arbitrarily by the United States in a series of deals."

The size of the U.S.A. quota was largely influenced by an accounting and political convenience. It was 35 percent of the total quotas at the time. Because dollars were then the Fund's virtually only usable currency, it was the stock of \$2 billions of dollars plus 1.3 billion of gold that represented the Fund's effective resources.

The articles provide for a periodic revision of quotas, and for a special review every five years. In the first ten years of its life the Fund was largely passive and inflexible. This was a period of strong American influence, almost domination, which left an unfortunate legacy in French and other continental suspicions later on. In 1947-55, gross drawings (i.e., not debiting repayments) from the Fund totalled no more than \$1.2 billion. With the arrival of Per Jacobson from the B. I. S. as managing director of the Fund in 1950, the drawings increased and by early 1968 drawings in the 21 preceding years reached \$14½ billions of this Britain alone had taken over \$¾ billion. The next largest drawer on the Fund, by absolute amount, as distinct from percentage of quota, was the United States, with \$1,640 million drawn: followed by India (1,090), Canada (\$726), France (\$519) and Brazil (\$503).

While the Bretton Woods Code envisages the use of exchange rates to correct a fundamental disequilibrium, the Fund's particles do not help it to promote this quota. Formally, the Fund is entirely passive on exchange rates. Art IV, Section 5 (b) provides that a change in a par value may be made only on the proposal of the member - though, there is of course no article that obliges the Fund to lend to a member country whose exchange rate it considers to be out of line. The Fund has in fact, adopted a very flexible approach to exchange rates in its dealings with the smaller trading countries. During the Jacobson regime (1950-63), when a world of fixed rate convertibility with unhindered capital movements seemed for a time more credible than it did before or has done since, the Fund at times committed its prestige to the preservation of existing pattern of exchanges rates among the leading currencies. Subsequently, it has become rather more guarded. It has recognized, at least conceptually, the role of last resort exchange rate variations. But its concern with exchange stability in general and with the avoidance of speculative disturbances puts it in a tricky position in publicizing that attitude. While exchange rates remain changeable only in sudden, in calculable steps, the conflict is likely to remain.

EVALUATION OF THE WORKING OF I.M.F.

The growing problems of the U.K. in her balance of payments, and the erosion of the international status of sterling, clearly indicates that the I.M.F. has been unable to administer the classical medicine to the U.K. Further the Fund has also failed in persuading the United States to play the rules of gold exchange standard. Her balance of payments deficit got very much out of hand. The Fund has not succeeded in advising the U.S. to make the needed exchange rate adjustments. The Fund has also failed to impose multilateral surveillance upon the U.S.

The Fund must be the main source of short-term funds to countries in balance of payments difficulties. Only when it performs this action, can the Fund influence the internal economic policies of the deficit countries. The European countries—central banks and their governments—and the U.S. have almost acted as rivals to the Fund. The phenomenon of currency swaps points to the by-passing of the Fund even as a clearing house.

The Fund has almost failed in persuading the U.S. to revise the price of gold. The Gold Pool device failed to keep down the market price of gold. The Fund has now embarked upon the introduction of a new reserve asset, though initially it showed its reluctance in doing so. It preferred to experiment with quota increases, liberalisation of trauche borrowings and augmentation of its resources through General Arrangements to Borrow. It is only later that the Fund began to think in terms of a new form of liquidity automatically increasing year by year, and deemed unconditional. The Fund's proposals for the special Drawing Rights may be interpreted by some as another device to escape the basic issue of gold price revision.

The Fund has helped the under-developed countries in meeting their short-term problems of payments arising from the need of development. There is dispute whether the quantum has been adequate and whether the Fund has persuaded the underdeveloped countries to abandon exchange controls and whether the advice regarding exchange rate change has been suitable.

Some economists would criticize the post-war monetary system as being grossly inefficient in respect of its ability to impose adjustments speedily and in time. The mechanism of adjustment, according to them, should be automatic, impersonal and continuous. The deficiency in this respect is more serious than the inadequacy of liquidity.

The I.M.F. may be defended as it was never specifically charged with the duty to formulate domestic monetary and fiscal policies. It must take them as given. Secondly, the I.M.F. was not designed to be the sole source of short-term funds; it was to be only a lender of the last resort whether the fund has been successful or not should be judged by:

- (a) whether the initial parties were viable parties;

- (b) whether the tendencies towards fundamental disequilibrium were noted in times and corrective action was properly advised upon ;
- (c) whether the individual countries, which were advised to devalue, were enabled to tide over the short-term liquidity gap ; the fear of emergence of which, would have discouraged devaluation ;
- (d) whether after devaluation, the countries were restored into equilibrium states and
- (e) whether the Fund arrangements were sufficiently elastic to permit the growth of supply of suitable forms of international liquidity.

“Looking at the experiences of the U.K. and the U.S.A., the relations between the U.S.A. and the Western Europe, and the breakdown of the efforts to maintain a single uniform gold-price, it is not clear whether the Fund can be credited with major achievements. Nor is it time that equilibrating tendencies are gathering momentum, and that the world community is converging to an agreed solution, which is also lasting. It is not even correct to hold that in the post-war world, major recessions did not occur ; nor have the major countries continuously maintained full employment. In fact unemployment has been a recurring sore in the U.K. and the U.S.A. Balance of payments deficits have persisted in spite of unemployment. Many countries have maintained high reserve positions though they have lost some “growth” thereby. There has been a frequent complaint in the West Europe that inflation therein has been primarily involuntary ! being imported due to the U.S. deficits. That deficit positions did not imply reduced money supply and falling price levels, and that ‘surplus’ positions did not imply expanded money supply and rising price levels, is a major indictment of the working of the Post-War monetary system. It is not clear whether this can be said as due to the non-playing of the rules of the game, or to basic weakness of the system itself. It may even be that under the post-war monetary arrangements the sight rules of the game in the interests of the countries required the build-up of gold reserves and the losing of gold reserves. The clock room rule of reserves may be the ideal rule for the gold exchange standard when the key-currency country started incurring large deficits. Why do we expect the gold exchange standard to duplicate the gold standard.¹

As a way of bringing about desired modifications, the following suggestions are made : (i) IMF should be converted into a central bank (ii) exchange rate movement should be more flexible in an enlarged range (iii) the fixed rates system should be abandoned (iv) the gold price should be changed to reflect the changing circumstances (v) the Fund should introduce a new liability (vi) the price of gold should

1. P.R. Brahmananda, *The Gold Money Rift* (Bombay, Popular, 1969, pp. 152-153)

register steady rise every year. Some of these suggestions are contradictory to each other. In the issuance of a new liability of the Fund, it has also been suggested that the asset should be counter-parted with capital investments in under-developed countries or with purchases of stocks of primary commodities combined in a fixed proportion. A new media on the basis of a mixture of several currencies, particularly of rich countries, taken in fixed proportion has also been suggested.

The I M.F.'s final scheme combines the ideas of (i) fixed-proportion multiple currency reserves (ii) mutual drawing accounts with reciprocal obligation (iii) a currency or deposit liability issued by the Fund and (iv) adhoc schemes like currency swaps and institutionalized General Agreements to Borrow. The new reserve asset termed special Drawing Rights is not a liability of the Fund. The SDR are allotted to participants not on the basis of new accrual of gold to the Fund to the extent of gold-equivalence of SDR's, nor do the rights flow out of investments by the Fund in the countries of the participants. They are 'created' by the Fund on behalf of the participants, and in the first instance accrue wholly to the participants. The Fund may hold SDR's, when the latter are transferred to the Fund, in the form of payments by the participants of charges, for repurchases of member's currencies, and for repayment of loans to the Fund given by the latter in the form of SDR's. The participants can obtain SDR's from the Fund, when they need them for reconstitutions, by paying gold and/or foreign exchange (gold convertible). Hence the Fund can maintain SDR's to its own credit in the General Account, and when the need arises from the participants, can transfer or sell SDR's to them. But in the first instances SDR do not accrue to the Fund.

The special Drawing-Rights variously described as a legal tender is in international payments, a major benchwork in the evolution of international monetary system, and lauded as an innovation in international economic life on par with the creation of paper currency in the national economies substituting regular coins in gold or silver, are designed to act as a supplement to traditional reserve assets such as gold and foreign exchange in the form of reserve currencies. Under the Articles of Agreements as amended, there will be maintained in the IMF, two separate accounts, a General Account and a special Drawings Rights Account. The Fund will carry on its present operations and transactions through the General Account, and its functions in special drawing rights through the special Drawing Account. Assets and property as well as liabilities and obligations will be separated.

Participation in the Special Drawing Account will be open to members of the Fund and only to them. To become a participant in the Special Drawing Account, a member will have to deposit with the Fund an instrument setting forth that it undertakes all the obligations of a participant in the Special Drawing Account. Members that have at least 75 percent of the total quotas in the Fund must deposit their instruments first.

Allocations of SDR's may be made only to participants, but the holding of such rights is not restricted to participants. The Fund itself can accept and hold Special Drawing Rights in and use them through, the General Account.

The Fund by a special majority (85% of voting power) will be able to permit non-members and members that are not participants to engage in operations and transactions involving SDR. Other holders that the Fund could authorize would be institutions that perform one or more functions of a central bank for more than one member. Regional organizations in which members or their central banks pool some of their reserves and the Bank for international settlements are considered to fall within this description. The operations and transactions between participants and other holders will be subject to the requirement of 'need.'

The basic principle governing all decisions to allocate or cancel special drawing rights is that the Fund must seek to meet long term global need, as and when it arises, to supplement existing reserve assets, in a manner that will promote the attainment of the Fund's purpose, and will avoid economic stagnation and deflation as well as excess demand and inflation in the world (Article XXIV) Certain special considerations shall be taken into account before SDR's are first allocated. The first special consideration is that a collective judgment (reflected in a special majority of voting power) that there is a global need to supplement reserves. A second special consideration is the attainment of a better balance of payments equilibrium, and the third is a likelihood of a better working of the adjustment process in the future.

Decisions to allocate or cancel special drawing rights may be made only by the Board of Governors on the basis of proposals from the Administration of the Fund and only by a special majority. The Managing Director is required to make proposals and report at certain times and in certain circumstances in this connection.

Special drawing rights may be used only in the operations and transactions authorized by or under the provisions of the Articles.

Participants are required to inform the Fund of any operation or transaction involving SDR's that they enter into among themselves and with other holders.

SDR's will be allocated cancelled over periods referred to as "basic" periods, which normally will be five years in duration and which will run consecutively. Allocations to participants will be made at yearly intervals and on the basis of their quotas on the date of the relevant decision to allocation unless the Fund decides otherwise.

The concept of the consecutive basic periods does not prejudice Fund's discretion based on its assessment of need of additional reserve assets to allocate SDR's or to cancel SDR's or to do neither. Basic

periods can be employed periods *i.e.* in which there are neither allocation nor cancellations.

A member that becomes a participant after a basic period has started may receive allocation during that basic period, at the discretion of the Fund.

A participant whose governor did not vote affirmatively may "opt out" of allocations under a decision by giving notice to that effect. A participant that has opted out with respect to a basic period may "opt back in" (*i.e.* resume receiving allocations) within the permission of the Fund, but the participant will receive only the allocations made after it has been permitted to opt back in; however no retrospective allocation, can be received.

The basic financial obligation that each participant will assume will be (Article XXV—sec 4) to provide currency convertible in fact, when the participant is designated by the Fund, to another participant using its special drawing rights, upto a total net amount of S.D.R.'s, allocated to the designated participant. The participant providing currency will receive an equivalent amount of S.D.R.

S.D.R. will be issued by the Fund but they will not confer on participants a claim against the Fund itself to provide currency except in connection with termination of participation and liquidation. Participants will be able to use S. D. R. to obtain currency from other participants as per Article XXV. This article requires the Fund to designate participants using their S. D. R. so that participants can be assured that at all times they will be able to use their S. D. R., in a manner consistent with the provisions of the Articles.

Under Article XXV, Section 2 (b) (ii) the Fund is given the power to prescribe transactions in which a participant may engage in agreement with another participant, whether designated or not. As a general rule, as participant will be expected to use S. D. R. in transactions with other participants only if it has a need as defined in Article XXV Section 3 (a). These refer to "developments in its (a participant's) official holdings of gold, foreign exchange, and S. D. R. and its reserve position in the Fund, to indicate that these developments even if attributable to conversion of balances of the member's currency and not to a balance of payment deficit, may give rise to a need to use special drawing right.

Under Article XXV, Section 3 (c), the Fund is authorized to prescribe transaction in which participants may use the S.D.R.'s without fulfilling the requirement of need. These are: (a) to help reconstitution by any other participant; (b) to prevent reduce a negative balance by the other participant; (c) to fulfil the expectation of (a) and (d) to bring the holdings of SDR's by both participants closer to their net cumulative allocation. A participant may provide currency in excess of the obligatory limit or any agreed higher limit (Article XXV Sec. 4).

Interest will be paid by the Fund to a participant on the excess of its holding of SDR over its net cumulative allocation, and charges will be paid by a participant on the amount by which its holdings of SDR are less than its net cumulative allocations. Interest charges will be paid in SDR. The rate normally should be $1\frac{1}{2}$ percent per annum. The expenses of conducting the business of SDR are to be met by the Fund from the resources held in the General Account.

Decisions on important matters requires 85 percent majority are to be taken by the Board of Governors. The suspension of a participant; use of SDR are not to affect the participants right to use its SDR. Similarly withdrawal from SDR is not to affect the participants membership of the SDR.

The provisions of Article XXXII (b) are designed to ensure that any participant using SDR to obtain, "currency convertible in fact" from a designated participant can obtain, directly or indirectly, any one of a number of convertible currencies that he may choose, in amounts determined by the exchange rates prescribed under Article XXV, Section 8, in accordance with the principle of equal value.

This objective is to be achieved by establishing a group of currencies which will be interconvertible at appropriate rates of exchange for balances arising in connection with the use of SDR.

Change in quotas, including special increases and increases by instalments, as the result of a general review, will require now a special majority, i.e., 85 percent of the total voting power. All other changes in quotas will continue to require a $\frac{2}{3}$ majority of the total voting power. Similarly a decision to make a uniform proportionate change in par values will require 85 percent voting.

Requests for gold trauche purchases now enjoy defect automatically. Now as a result of amendments, there will be legally automatic. Gold trauch purchases can be used for meeting capital transfers. A member will be able to make gold trauche purchases even though they are to meet what might be regarded as a large or sustained outflow of capital.

As a result of the adoption of Article V Section 3 (d), the Fund will not have the power to create any new facility in the General Account for the unconditional use of its resources. This provision reflects the view that, with the establishment of this new facility based on SDR, any need for additions to existing reserves assets will be met, as and when it arises, through allocations of SDR.

Evaluation. Would the activation of the SDR remove the ills afflicting the U.S. economy? According to the calculations of Mr. C. Gordon Tether of the "Financial Times", this sort of reinforcement (the U.S. will be getting about \$500 million annually under the new arrangement) of the U.S. reserves would take not less than about 40 years to give the necessary backing the dollar had at the

beginning of the 60's. Mr. Paul Bareau is of the opinion that some element of convertibility of SDR's into gold will be needed as a measure of discipline even though the control of the issue of SDR's is going to be in the hands of—no doubt responsible—of the IMF. What is more, as the role of SDR's is going to be one of the supplementing and ultimately replacing, not gold but the national currencies which have proved the dynamic element in the international reserves, confidence in them will depend only on some measure of real convertibility with gold. Such convertibility will be required, if international monetary system is to retain its essential capacity to operate an "equilibrating mechanism", says Mr. Paul Bareau. In a nutshell, the logical culmination of the creation of the SDR will, in fact, be to hasten the conversion of dollars and pound sterlings into gold especially when the two reserve currencies have lost their greatest asset and quality in the form of free convertibility of gold.¹

Sharp criticism is made by Mr. P. R. Brahmananda, "Special Drawings Rights are not generalized claims on international purchasing power. Their circulation depends upon the fulfilment of the SDR—currency swap obligations by countries to be designated against. Any given country may not get the currency of that country which it desires. The amounts of SDR's cannot be significant enough to make an impact upon the liquidity problem. SDR's are of an assistance in times of speculative crises; nor can SDR's be accumulated and decumulated at the will of different countries. SDR's cannot be carried over intertemporal periods, and hence, will not serve as suitable media for settling debt claims. The sacrifice in alternative liquidity arrangements lost by the introduction of SDR's in the immediate years ahead."²

The SDR Scheme and Under-developed Economies.

The under-developed countries are likely to reap greater benefits under the SDR scheme because (a) the liquidity provided to the under developed countries will be greater in amount than by any other measure of augmenting liquidity; (b) the flow of capital to under developed countries will increase because the SDR will increase the real incomes in the developed countries and finally (c) the under developed countries are likely to benefit because of increased authority given to the IMF under the SDR scheme, the presumption being the IMF is favourably oriented towards underdeveloped countries.

However, the underdeveloped countries are hardly in a position to affect the working of the IMF working since the developed countries can command the necessary 75 percent voting power. However when the voting required is 85 percent, the developing countries may be in a

1. K. L. Bagal, *The Special Drawing Rights—An outline* in P. R. Brahmananda's *Gold Money Rift* (Popular Prakashan, Bombay, 1969 pp. 282—293).

2. P. R. Brahmananda, *The Gold Money Rift* (Bombay, Popular Prakashan, 1969 pp. 229-230).

position to influence, but here their mutual decisions and clash of interests should be taken into account.

The under-developed countries do face the possibility of some additional inflation in their countries as a result of the demand generated through SDR's for their goods. Besides the SDR's are likely to delay the working of the adjustment processes in the developing countries and thus postponing the crisis rather than scotching it. Finally, it is certain whether under-developed countries would not have reaped greater advantage if international money were neutral. Thus the underdeveloped countries may become the net losers.

Selected Readings

1. P. R. Brahmananda : The Gold Money Rift.
2. Fred Hirsch, : Money International.
3. G. R. Ponkshe ; World Money in Ferment.

- Q. Examine critically the various issues raised by Britain's possible entry with the European Common Market.**

Or

How India is likely to be affected by the enlarged European Common Market? Suggest suitable measures which could enable India in proper adjustment.

Or

Discuss the possibility of an Asian Common Market.

Or

Write brief notes on :

- (i) The Central American Common Market**
- (ii) Tariff and non-tariff barriers in some Asian countries.**

Ans. EEC Commission On British Entry

The Treaty of Rome requires the EEC Commission to give its "opinion" on new applications for entry. The Commission in its report, welcomed the British to the EEC because countries with "political traditions of balance and democracy, which are so old and so deep", could make a major contribution to the EEC.

However, it prescribes "measures of adaptation, permitting a return to lasting equilibrium". It hints that Britain should devalue the pound sterling. It advises that the six countries should be consulted before any such major action is taken.

It also argues that the pound sterling should be stripped of its status on an international reserve currency, which it shares with America. It is hinted that a European currency should enjoy that status. The whole idea of the Treaty of Rome is to maintain equilibrium on balance of payments within the community among all its members. The idea is not to have one member endangering the rest of this community by going outside for help. "If the role of the pound as a trading currency cannot be put in question, it is difficult to see how, after admission to the community, this currency could continue to enjoy a different position in the inter-

national monetary system from that of the currencies of other member-States."

European Economic Community and India.

Since January 1, 1970, the member-States of this EEC can no longer conclude or change commercial agreements with other countries by themselves. Instead, commercial agreements are negotiated and conducted by the commission of EEC on the basis of a mandate given by the Council of Ministers.

Prior to 1970 common policies were largely in the field of agriculture and commerce. Now they are likely to share common policies in respect of monetary and general economic policies. They have already agreed to have greater co-ordination in respect of all policies for the next ten years.

The British as well as the entry of Ireland, Denmark and Norway, would increase the EEC's share of world trade to 33 percent from 20 percent when these countries were not there. It would be in a position to influence the prospects of world trade more than any other single partner. Besides a large number of countries are tied down to EEC. Almost 48 additional countries besides the 10 would have concluded special and often preferential commercial agreements. It participated in the Kennedy Round of GATT talks for trade liberalisation in 1967 and made its presence felt. However, after 1967, the trend has been towards a stoppage of the development of liberal conditions in trade.

A major performance of the EEC has been its agreement on generalised system of preferences at the United Nations Conference on Trade and Development. It is in a position to implement the agreement.

It has been, according to its spokesman interested in maintaining conditions of free trade not only in multilateral context but also in bilateral context. At present she has been engaged in negotiating a commercial agreement with Japan to contribute to increasing liberalisation of trade. It is also engaged in maintaining agreements with countries of Eastern Europe. They are also engaged in negotiating commercial agreement of a preferential character with the U.A.R. and Lebanon. They feel special interest in the Mediterranean region. In case of Africa the communities have got preferential agreements with 21 African States. They have also promised to extend the similar preferential treatment to nine Anglo-African States in case of the British entry. They have set up a European Development Fund, which permits direct aid as well as technical assistance to the African countries.

The Council of Ministers of the EEC responded favourably to an appeal of 22 Latin American countries for closer co-operation on a multilateral basis, *i.e.* with all the 22 countries at the same time. One doubts

whether India is at the end of a queue or it is left out from the communities activities as mentioned above.

One might say that, notable in case of some countries of Asia, there is a particular combination of general and similar conditions which have to be dealt within a similar and possibly in a general way and specific conditions, which can only be dealt with in bilateral relations and by the instruments of such bilateral relations. Bilateral, according to community, implies that it is acting as one of the partners in such relations. The system of generalised preferences will affect imports into the communities of a value of approximately \$1 billion a year. India is likely to be most affected by this development.

The conclusion of international agreement in the field of raw-materials should be of concern to India. Some agreements with the EEC have worked well. The cotton agreement is rightly regarded as a model of goodwill agreement between the EEC and India. The same, however, cannot be said about the items of jute and coir.

Trade between the EEC and India is still relatively limited. Export from the communities of India have been registering a continuous decline while the exports of India to the EEC have been on the increase. This is likely to reduce the trade deficit with the communities.

India is strongly interested in bridging her trade gap, but she is more interested in increasing her exports. This can come about provided (1) India accepts the fact of inter-dependence in international life and refrains from following a policy of domestic self-sufficiency, (2) India would increase her exports and permit the volume of imports to remain the same. If it reduces imports, it is likely to hit its exports in the long run and (3) finally, the EEC definitely feels interested and actively assists the needy countries in their development programmes.

According to the EEC, they are not another club of the rich, but are interested in closer political union so that international peace and prosperity is strengthened. India and the EEC need to co-operate not only in the field of commodities and tariff barrier, but also need to co-operate about non-tariff barriers on either side. They need to explore the possibilities of joint ventures and help each other to achieve the objective of export promotions.

Modern commercial policy is not simply a policy of exchange of commodities but is one of international economic co-operation. Keeping this end in view, there is a basis for closer co-operation between India and the EEC.

Asian Regional Economic Co-operation

The case for regional economic co-operation in the ECAFE region can be supported on the basis of the considerations given overleaf.

Significant proportion of world trade (*i.e.* 32 percent of world trade) occurs among the Asian countries. However, if we exclude Japan, Australia and Newzealand, the proportion is reduced.

Their (Asian) trade with the rest of the world has been continuously declining and was about 15 percent in 1968. Thus there arises the significant need for increasing intraregional trade, if the targets of rapid economic developments are to be attained.

Such a potentiality exists, because taken as a group, the countries share some complimentaries in their economies. We have in this region Japan, a highly industrialised economy, Australia, rapidly industrialising, Newzealand with a developed primary products economy ; semi-industrialised countries like India, Iran and Pakistan ; oil economies of Iran and Brunei, and most other developing countries specialising in a number of primary commodities like rice (Burma, Thailand, Combodia) rubber (Malayasia and Indonesia) tea (India and Ceylon) and Jute (India and Pakistan). Since many of the countries lack these commodities, there exists a basis for gain from trade liberalisation measures.

These countries developed their production pattern under historical compulsions. If mutual trade possibilities are increased, more dynamic and rational structure of production is likely to emerge over time.

Many of these countries like Ceylon, India, Pakistan and Indonesia suffer from chronic balance of payments deficits and consequently have adopted many restrictions on imports and exchange etc. Obviously co-operation among the deficit countries is required to find a way out of payments problems.

The Asian region shares common features and is a geographically knit unit. Transportation costs are likely to be lesser in the region. Immediate adaptation of supply to changes in demand is likely. Hence the need for greater regional co-operation in the matter of trade.

Regional Monetary Co-operation

At present the claims are settled largely in the developed currencies of West *i.e.* dollar and pound because these are convertible. Hence the banks of these countries maintain working balances with the banks of U.S.A. and U.K. and other countries with hard currencies. They pay charges to the foreign exchange dealer for providing the necessary services. Besides double concession is involved. For instance, Indian rupee is converted into dollars and these are again converted into yen, (Japanese currency) and this conversion takes place at unfavourable rates. In addition, the local banks of the countries of the ECAFE region at both the paying and the receiving ends charge their commission for providing services for currency exchange.

It has calculated that till cost of settling the inter-regional trade

would be reduced by the extent of 0.75 percent of the value of the turnover of compensable inter-regional trade in any particular year, which works to about \$110.2 million of which \$10 million would be in hard currencies and the rest in national currencies of the union.

An Asian Payments Union

The nations of these regions are likely to require very large amounts of credits if they are to accelerate their industrialisation programmes and without facing imbalance in the balance of payments. The clearing union is likely to satisfy this need to a limited extent. Since the additional trade is likely to generate additional imbalance, the need for reaching some kind of an agreement on this mechanism for negotiating smooth payment, is apparent. The formation of a reserve fund by contributions in gold, foreign exchange and SDR from the member countries of this region in some defined proportion (say 10 percent) of their own international reserves would lead to considerable strength to this smoother operation of a programme of regional trade liberalisation.

An Asian Reserve Pool

The reserves of the entire region should be conserved in the form of a reserve fund, because these vary on the basis of time. Reserves are held for meeting their deficits in their balance of payments and the amount of required reserves bears a direct relationship to this expected variation in such contingencies. As a result of reserve fund, the region could do with holding of less reserves collectively than by each State, and thus consume a lot of foreign exchange. The conserved resources could be used for earning more outside the region or used for supplementing resources for economic development of the member countries.

According to third scheme of ECAFE, each country would contribute a commonly agreed fraction (say 5 percent) of its international reserves in gold or convertible currencies to the Reserve Fund. A member country originally would have full title to its contributions and access to such resources in the case of its needs for balance of payments purposes. It would also be able to borrow upto some agreed multiple of the amount of its deposits according to the agreed drawing rights. Credits would be granted to member countries with due regard to their overall balance of payments positions (not just regional positions) and the deficit countries would be asked to follow corrective policies.

The Asian Reserve Fund (ARF) would be different from IMF because it would be an institution of its own member countries, would provide them supplementary funds for financing regional trade expansion, would invest surplus funds of the member countries outside the region for earning higher interest and would provide supplementary finance for economic development of the region.

The response of the countries of the region towards the A.R.F. is

cold since they do not like to commit any proportion of their international reserves because of their stringent payments situation. But a few countries are interested in the idea of Asian clearing union.

Implications for India

India must export or perish. She has faced continuous payments deficit because (1) she requires larger and larger amounts of development and maintenance imports, (2) her exports have not been keeping pace with the increasing imports, (3) her external debt has been continuously increasing and debt securing charges have assumed huge proportions, (4) aid from foreign sources has been slow in coming, (5) private foreign capital has been relatively shy in her case, (6) import substitution programmes have tremendous economic costs and finally (7) other countries of the region have been doing better on the front of exports. In this context, India must search new markets and the search for Asian common market is appropriate because of geographic location and proximity to consuming centres.

India has achieved greater degree of industrialisation and can export non-traditional items to other developing countries of the region. The Indian economy provides some complementarity to the economics of countries in the ECAFE region. As such when trade is liberalised, India is likely to benefit and would have a greater turnover of trade of non-traditional items within the region.

On the sub regional basis, India and Pakistan have complementary economies and can have a joint policy of several products. With the emergence of Bangla Desh, chances of sub-regional co operation with Bangla Desh are brighter. Their economies are more complimentary and India is likely to find a booming market in the Bangla Desh.

Similarly, India and Ceylon can have a uniform policy for the export of tea. Iran can help India in her oil industry, can provide inputs for fertilisers industry. India can provide material and technical know-how for setting up joint ventures in Afghanistan, Ceylon, Nepal and in several South East Asian countries. India can also expand her export of non-traditional items to these countries.

India's participation is also likely to carry some costs which are following :

(1) Some domestic producers may be hurt because of trade liberalisation (2) Government may face a reduction of revenues. (3) Liberal imports may aggravate her balances of payments position. (4) India may have to import several commodities which it can produce at home with lesser costs.

India has several items to export to countries of this region, but

they do not have many items to export to India. However, on balance, India is likely to benefit in the long run.

The trade liberalisation has not been possible because (1) Pakistan has always followed hostile policies, (2) Nepal has not shown due understanding as trade and transit issues and (3) Burma has been too much conserved with self-sufficiency. Similarly, India stands to gain a lot from friendlier contacts and understanding with the South East Asian region. India has to be aggressive in her export drive. She has to supplement bilateral with multilateral and regional agreements.

From the clearing union India could, according to one estimate, save about \$6 million a year. The gains would have been in the region of \$2 millions if such union had been established between the developing countries only.

Similarly, India has nothing to lose if she joins the regional payments union because she has been a chronic deficit nation. India must participate in the Asian Reserve Fund, because at present she can contribute her share of contribution of gold and foreign exchange, she is always likely to benefit from the fund because her requirements are likely to be greater for a period to come.

BACKGROUND INFORMATION (I)

Tariff and non tariff barriers in some less developed countries.

Afghanistan. No quantitative restrictions—No preferential duties—Import duties ad valorem on fixed values.

Burma. Single column tariff—No preferential duties or customs surtaxes. Essential goods not taxed, but luxury goods heavily taxed.

Ceylon. A complete structure --Rigid import licencing schedule based on various classes of goods and imports—Preferential tariff on imports on commonwealth countries.

India. A labyrinth of controls—Importers classified into various categories as goods. Foreign exchange strictly controlled by the Reserve Bank. Ad valorem import duty weighing heavily against luxury items—number of items prohibited for imports—Preferential treatment for commonwealth countries and for those countries with whom special arrangements have been signed.

Indonesia. Strict import control somewhat on the Indian model—two column tariff, one a general schedule and the other for imports from members of GATT.

Malayasia. Liberal licencing policy—most goods imported on

O.G L. basis—combination of ad valorem and specific duties—two column tariff with preferential commonwealth schedule.

Background Information (2)


The Central American Common Market—An Assessment of its working

The five participating countries to the General Treaty for Central American Integration in 1960 were Guatemala, El Salvador, Nicaragua, Honduras and Costa Rica.

The results of the union have been impressive. The external trade of the area grew faster than GNP and inter-regional trade increased faster than total trade. In 1960 intra-trade formed only 6.4 percent of total trade; in 1965 the proportion was 15.8 percent. Economic union meant increased capacity utilisation and better allocation of resources. The trade diversion effect was conducive to greater economic welfare.

The problems looming large in the near future are many. Firstly, there is the need to ensure equal regional development and to determine the location of industries accordingly. Secondly, the common external tariffs could mean "static non-compressible imports" in the face of fluctuating export earnings with accentuated balance of payments problems. Thirdly, the ever increasing flow of foreign capital may reverse direction during adversity with added pressures on foreign exchange reserves.

The outlook on the whole is, however, promising. Tax structures have been modernised and forward-looking enterprunerial generation created. The various lending institutions and the alliance for progress have committed large sums of assistance in view of the apparent approach of the "take-off" state.





Q. Discuss the function and objectives of GATT. To what extent has it been helpful to the under-developed countries? Or

Evaluate the GATT from the point of view of the less developed countries. Give suitable suggestions for reforming the present state of affairs.

Ans. General Agreement on Tariffs and Trade

The contracting parties to this Agreement aim at contributing to the objectives given below, by entering into reciprocal and mutually advantageous arrangements directed the substantial reduction of tariffs and other barriers to trade and to the elimination of discrimination in international trade.¹

1. Raising standard of living.
2. Ensuring full employment and a large and steadily growing column of real income and effective demand.
3. Developing the full use of the resources of the world.
4. Expansion of production and international trade.

These objectives are to be achieved by the promotion of free and multilateral trade. It should be noted that tariff and trade restrictions are to be reduced substantially and not to be abolished. In other words, trade barriers were preserved to survive. Further, 'substantial' does not apply to 'elimination' of discrimination. In other words, discrimination is accepted as a normal feature. Finally, the reduction of the tariff and the elimination of discrimination is to be on a reciprocal and mutual advan-

(1) Preamble to the General Agreement on Tariff and Trade.

tageous basis. The idea of strict reciprocity discriminates against the UDC. Besides, the Articles of the General Agreement do not insist on strict reciprocity¹.

The GATT was a unique experiment in multilateral commercial diplomacy and arose in 1948 from the various post-war discussions on the reforms of the international monetary system. The Havana Charter was never ratified but the GATT came into existence in 1948 as an instrument for promoting free trade, multilateralism and non-discrimination in international trade.

GATT established a set of rules regulating commercial policy on a contractual basis among the contracting parties and has a total membership of 75 nation with 3 being the LDC. The fulcrum of the GATT is the 'most favoured nation clause whereby member countries grant one another treatment atleast as favourable as granted to any other party—with the provision that under certain conditions custom unions and free trade regions could be formed. GATT also specifies that protection should be extended exclusively by tariffs and not by quantitative restrictions.

GATT's principle of reciprocity assumed an equality among countries which never existed. The LDC had to constantly pursue for protection of their infant industries and exports of primary products. Free trade and multilateralism remained pious platitudes. In assuming the obligations of GATT, the LDC have found it difficult to release foreign exchange for input imports and to accelerate exports.

GATT provided for short-term imbalances ; long-term structural imbalances were completely lost sight of. The advanced countries retained restrictions on balances of payments ground. Quantitative restrictions were outside the scope of most favoured nation clause. Waive clauses, escape provisions, minute tariff classifications, these and other devices impeded the full flow of trade liberalisation. Policies of protection retained unabashed predominance. The French openly declared that free play could not be permitted in respect of agricultural products.

The LDC have not been able to make much use of the special provisions (Art XVIII A and C) for alleviation of their obligations, however, this is mainly due to the fault that restrictions seem to be defensible on virtually all grounds. The LDC have also not been able to participate actively among themselves in the successive rounds of tariff negotiations as a number of trade barriers, although negotiable in theory, have proved to be semi-permanent, such as the various compensating and differential levies. Most of the rules are complicated with restrictions regarding principal supplies a 'substantial interest' which are mainly inapplicable to the LDC. Any advantages that have accrued to this LDC stem from indirect

(1) Dr. K. R. Gupta, International Economics (Delhi, Atma Ram & Sons, 1969. pp 388-389).

gains as a result of negotiations between affluent countries extended grudgingly under this 'm-f-n' clause.

In 1963, an Action Programme listed a seven point course of action to promote the cause of the LDC—duty free entry of tropical products 'stand still' on new trade barriers, elimination of quantitative restriction, elimination and reduction of tariff on primary products and semi-processed and processed goods, reduction of fiscal levies and annual 'implementation reports'. These aims are yet far from being fulfilled notwithstanding the Kennedy Round concessions.

The basic drawback of the GATT is that it is founded on the theory of comparative costs which has only a limited validity for developing countries.

Irrespective of comparative advantage most developing countries are unable to export goods even when their prices are competitive as they have to face an export maximum determined by domestic supply inelasticities and foreign demand inelasticities. Factor proportions and product functions became irrelevant. For manufactures to be competitive in the richer countries markets and at the same time pay at least subsistence wages in the domestic spheres, the real cost of foreign exchange would have to be very high. It would be far too high in relation to the rate required to market primary products. The exchange rate may lead to a glut of supplies of primary products and reduce their price. Thus, the terms of trade turn adverse. Production is not high enough to sustain the factors of production required to produce goods with a comparative advantage. Because of the foreign exchange gap, transformation of the domestic factory into inputs is hindered, exports lag and do not lead in industrial growth.

GATT has not served the interests of the developing countries as it has the developed ones. In short, GATT has not helped to create a new order which must meet the needs of development.

It has been suggested that GATT and UNCTAD should merge. The former would pass resolutions, but the latter would execute. In other words, a radical reversion of the scope and functions of GATT is required.

THE WORLD BANK

The International Bank for Reconstruction and Development—the IBRD or the World Bank—was founded at the International Economic Conference held at Bretton Woods in July 1944 and began its operations in the June 19-6. The Bank is an international co-operative organisation, associated with the United Nations, having the status of a specialised agency. Its aim is to assist the economic development of its member countries and raise the standards of living of the people of the world.

The Purposes of the Bank according to the Articles of Agreement are as follows :

(a) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for production purposes, including the restoration of economies destroyed or disrupted by war and the encouragement of the development of productive facilities and resources in LDC.

(b) To promote private foreign investment by means of guarantees or participations in loans and investments made by private investors and to supplement private investment by its own finances, and

(c) To promote the long range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of the members, thereby assisting in raising productivity, the standard of living and condition of labour in their territories.

Financial structure of the Bank

The initial authorized capital of the World Bank was \$10,000 million subscribed by its members in accordance with their economic strength. Each country's subscription quota was originally decided into (a) 2 percent of the quota to be paid in gold or U.S. dollars, (b) 18 percent of the quota to be paid in local currency and to be available for lending only with the consent of the member whose currency was involved and (c) the remaining 80 percent to be subject to call if and when required to meet the Bank obligations.

Management

All powers of the Bank are vested in a Board of Governors, which consists of one representative appointed by each country and which meets normally once a year. Most of the powers of this body are delegated to a Board of Executive Directors which usually meet once a month. There are at present 17 Executive Directors—and are appointed by the Big Five having the largest capital subscriptions and 12 are elected by the Board of Governors of the remaining members for a two-year term. The President of the Bank is also the Chairman of the Board of Executive Directors. The voting power of the Executive Directors are proportionate to the capital subscriptions of the country or countries which they represent. The President discharges most of the responsibilities and is assisted by several loan committees.

Guiding Principles of the Bank

In its lending operations, the Bank is guided by certain policies formulated on the basis of Articles of Agreement. These are :—

(i) The Bank should assess properly the repayment prospects of the loans.

(ii) The Bank should lend only for specific projects which are economically and technically sound and of high priority nature.

(iii) The Bank lends only to meet the foreign exchange content of any project cost, it normally expects the borrowing country to mobilize its resources.

(iv) The Bank does not expect the borrowing country to spend the loan in any particular country; infact, it encourages the borrowers to procure machinery in the cheapest possible markets.

(vi) The Bank maintains continuous relation with the borrowers so as to check the progress of the projects and to keep in touch with financial and economic developments in the borrowing countries.

(vi) The Bank indirectly places special importance in the promotion of local private enterprise.

The Operations of the Bank

The Bank makes loans and charges interest varying from 4 percent to 6 percent. In addition, it provides a wide variety of technical assistance in the form of investigation. The Bank has also been enabled to lend to IFC (International Finance Corporation). The operation of the Bank has led to following criticisms :

(i) Resources at the disposal of the Bank are inadequate, but these have increased considerably in recent years keeping in mind the purposes of the Bank.

(ii) Critics refer to the failure of the Bank to play any significant role in accelerating the growth of the L D.C. In latter years the assistance has increased relatively, and the Bank has provided very valuable technical assistance to LDC.

(iii) The Bank was assumed to be partial to Europe and American borrowers. In recent years the Bank has been lending to all parts of the world. It has specially increased its loan to LDC while loans to European countries have been declining.

(iv) Difficulties faced by the LDC in obtaining loans from the Bank, is another criticism directed against the Bank. It is pointed out that

(a) Specific, urgent and productive projects are difficult to identify and agree.

(b) Funds are required for general developments especially on social overhead but the Bank cannot give loans for that purpose.

(c) It has failed to assist private enterprise significantly because of the requirement of guarantee by the Central Bank.

(d) The Bank does not provide equity capital which is not available from ordinary investors for projects of public utility character.

(e) The Bank insists on payment in the currency in which it has loaned. This may not be possible for the LDC as they may be having adverse balance with the hard currency countries.

(f) The undeveloped nations have vast resources which can be exploited with liberal assistance from the Bank.

(g) Higher interest rates charged by the Bank irk many critics. The projects for which loans are taken yield low direct returns. Hence the interest rates should be lowered.

The World Bank, whatever its shortcoming, has been able to channelize private investment into public development projects in LDC. The needs of the latter are many and vital, hence greater liberalisation of the terms and amount of loan would be quite appropriate.

The Asian Development Bank

The Asian Development Bank (ADB) is a unique experiment. Its uniqueness lies in that the major part of the subscribed capital comes from the regional participating countries and a minor fraction from the developed countries other than Japan. Of the subscribed capital of \$ 965 million, \$615 million come from the following contributors :

	\$ million
Japan	200
India	93
Australia	85
Pakistan	32

\$ 350 million come from the developed western countries with the U.S. topping the list at \$ 200 million. Membership is open to countries outside the ECAFE region.

The Bank was opened towards the end of 1966 and its aims are to promote private and public capital investment in the ECAFE region, to render technical assistance in project development, and undertake any other activities that would advance its purpose.

The Charter of the ADB calls for generally "softer" loans—upto 10 percent of the "paid in" capital can be kept aside for this purpose—a welcome contrast to the lending policies of World Bank. The principle of a Special Agricultural Fund has also been accepted.

The ADB represents a unique blend of a global partnership and an Asian function, has emphasised agriculture, infrastructural development and soft loans. The performance has been encouraging. It can augment

its resources by selling bonds in the international monetary market.

An important principle established by the ADB is that a country is not deemed as not credit worthy because of balance of payments difficulties. The President Mr. Watanabe, remarked in his address to the UNCTAD, "A country without enough credit-worthiness is thus deprived of an opportunity of receiving a foreign loan, which may be unnecessary to undertake a project which could help reduce the balance of payments deficit. This vicious circle tends to perpetuate that difficulty."

The ADB faces a number of problems. If it gives a high proportion of soft loans, it will face grave replenishment problems. To build up reserves, hard terms and severe criteria have to be enforced. Trade restriction, direction of trade, national investment plans and production mixed in the member nations do not come in its purview. Basically the solution lies in the general aid from the rich countries.

Suggested Readings

- (1) K.R. Gupta : GATT.
 - (2) Harry G. Johnson : Economic Policies towards less developed countries.
 - (3) John A. Pincus : Trade, Aid and Development.
 - (4) Various Publications of GATT and UNCTAD.
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INTERNATIONAL LIQUIDITY

Q What is the problem of International liquidity. Examine 'the demand for' and 'supply of liquidity' concepts. Or

Give a brief historical review of the problem of international liquidity.

Ans. Historical approach to International Liquidity.

The 'golden age' implies the closed economy. The 'closed economy' prevailed when several conditions existed. These were : (1) all goods are inter-dependent with each other in production (2) the same proportion of goods is produced year by year, (3) techniques are constant, (4) consumption requirements are in terms of fixed proportions. (5) there is no initial unemployment, (6) the propensity to invest is strong enough to absorb all the potential savings, (7) population growth rate is positive and is constant and (8), land is in perfect elastic supply. These all lead to a certain fixity in capital, employment and output etc. so that stability becomes a virtue. One can easily work out the requirements of money as a medium of exchange and a certain store of value, as being technically dependent upon the volume of output. The rate of growth of requirement of money would be governed by the rate of growth of output.

However, growth of trade in a closed economy has been faster than the growth of output. Goods are changing. Technology is never static. Corruption patterns change continuously. Unemployment is common. Population growth is quite unstable. Land resources are limited. Savers and the investors tend to be different. State is an independent entity whose actions are decisive but unpredictable. Different countries have different political and economic set-ups and have different aspirations. They have differing extent of trade dependence upon others. The institutional structure are different. People react in different ways to growth inflation and external indebtedness. Consequently, the evolution of a proper inter-

national standard becomes difficult. Money cannot be a 'confidence trick' here if it is to be universally acceptable. Gold has historically been the standard of international liquidity.

But the supply of gold is inadequate and does not correspond to needs. If gold supplies fail to increase in the required manner, and alternative source of liquidity is not found out, defection may be a world-wide phenomena or there may be a world-wide exchange controls. Hence the importance of the issue of international liquidity. It is not simply the shortage of international liquidity. Shortage of liquidity may be a reflection of maladjustments in exchange parities and of the inflexibility of the current system in regard to rate adjustment. Some argue for a new and artificial device to tackle the problems. Others argue for founding the world monetary system once again on gold.

The theory of international money was first set out by Ricardo who suggested that gold reserves would tend to be distributed among different countries in relation to their relative capacity to export. In this way he was the pioneer of the concept of real liquidity. He also noticed how through inflows and outflows of gold among the different countries, stability in exchange rates would tend to be preserved. In an international system in classical equilibrium, both price levels and exchange rates would be stable.

This was the basis of international monetary practice in some form or another from the period of Napoleonic wars to the First World War. Economists were concerned when gold shortage was reported. They proposed bimetallic standard. However, during the post First World War period, the growth of trade at a boosted price level had to be conducted in a climate of growing gold shortage and of structural disequilibrium among different countries. The habit of using the U.K. Sterling and U.S. dollar as reserve currencies in addition to gold became widely prevalent, particularly after the Second Great Depression. The U.S. decision in 1935 in marking up steeply the dollar price of gold saved the monetary standard. However, the world economy has grown at a much higher pace now than ever earlier. Between 1965 and 1966 world industrial production almost doubled. If compared to 1938, it has quadrupled. Agricultural production has also been growing. The volume of world trade has been rising at about 7 percent per annum as compared to growth of output and income of around 4 percent. Price level has been slightly rising. Export prices and import prices have been relatively constant since 1951.

At present, 80 percent of the non-communist world G.N.P., its share in trade, and its gold reserves appear to be concentrated among the Rich Eleven Countries (U.S.A., U.K., France, Germany, Italy, Belgium, Canada, Netherlands, Japan, Sweden and Switzerland). Countries belonging to Western Europe have about 80 percent of the G.N.P. of that of U.S.A. and about 60 percent of gold reserves among the Eleven. Contrastingly,

immediately after the Second World War limited States had the predominant share of income, trade and gold reserves among the Eleven.

The post-war period has also witnessed a gradual resumption of convertibility among different currencies. The International Monetary System which has evolved in the post-Second War Period is a medley of the gold-standard, the gold exchange standard and a whole host of adhoc arrangements. The Second War saw the destruction of European countries and America as the major depository of world gold reserves and as a major source of capital flows to the rest of the world. The U.S. currency was turned into a major key currency because she had the largest gold reserves and also immense production potential. Dollar became the sheet-anchor of the post-war monetary system because it was convertible into gold and vice-versa and because it became the source of major capital outflows.

However, as West Europe recovered, it began to build up reserves for the normal purposes of maintaining high production and growth rates. As production and trade grew at a very rapid pace, the European search for reserves meant vertically the search for dollars. The concept of dollar shortage was developed in this period. The perpetual imbalancing from differing productivity growth and innovation rate between the U.S.A. and West Europe explained the dollar shortage. As long as West Europe was behind the U.S., capital flowed from the U.S. to Europe. It implied that West Europe, for its growth, became dependent upon rising capital outflows from the U.S. to her.

However, after the middle fifties the situation changed. West Europe continued its rapid growth and the U.S.A. kept on incurring budget deficits, the strength of dollar was weakening. The new argument was that the advantage of a key currency status endowed the U.S. with privilege of incurring the budget balance of payments deficits without, at the same time, seriously jeopardising its economy. This implied that the balance of payments deficit of the U.S. was a built in feature of the Gold Exchange Standard. The United States printed more dollars and attempted to command the increased world purchasing power. The West Europeans did not expand their currencies as a result of favourable reserves. They kept on building gold reserves. Hence the phenomena of dollar shortage.

Obviously the major cause changing the nature of international monetary system has been the transformation of a dollar shortage in Europe for a dollar glut therein. As a corollary, there emerges a shortage of liquidity for potential growth in the U.S. As long as the craze for gold persists, it is difficult for a currency or composite of currencies to replace gold as the most sought after reserve. Thus there is a qualitative aspect of the problem of international liquidity. Consequently, when we refer to the shortage of international liquidity, we mean thereby a shortage of gold or gold like assets in relation to the demand for it. The world monetary system seems to have returned to a lust for gold or rather to a solution of the gold shortage problem.

INTERNATIONAL LIQUIDITY—

What it implies ?

“The term ‘international liquidity’ refers to the supply of certain categories of financial assets or claims which are treated by all the different countries and international financial organizations in the international community, as receptacles of calculable ready purchasing power over all the domestic currencies in vogue. Gold is the ever-ready generalised purchasing power over all currencies under all standards. Under the gold standard, only gold possesses the property of international liquidity. Under the gold exchange standard, the currencies of those countries, which are willing to exchange gold and/or silver for their currencies offered by non-resident monetary institutions and vice-versa, come to enjoy the property. Such currencies are known as key or reserve currencies. Under the gold standard, the price of gold in terms of all currencies is specified and the monetary authorities are expected to maintain this price through economic policy adjustments and operations of open market or (even) transactions in gold under the gold exchange standard, the parity of gold with key currencies has to be maintained at least for official purposes.¹

Under the gold exchange standard, gold is supplemented in a large measure by holdings of key currencies (or short-term claims over them). Under a system of flexible exchange rates with parities fixed in gold and those currencies whose parities with gold are deemed as capable of remaining invariant are treated as liquid reserves. Currencies whose parities with gold are unstable do not serve as suitable stores of value nor as sound units of account.

Any individual country will include under liquidity the total supply of spendable reserves it can mobilize at short notice through adhoc arrangements largely on the basis of political connections between nations. However, such sources of supply do not constitute international liquidity. Historically the U.S. and U.K. have enjoyed this status of key currencies. Till recently dollar had a two way convertibility with gold because the U.S. was prepared to maintain the dollar price of gold in 35 dollars and was willing to sell gold in exchange for dollars to non-resident monetary institutions. (However, the U.S. does not, now, undertake to maintain this dollar price of gold and it has tried to get over the convertibility commitment by currency swaps and foreign currency loans. It has requested several governments not to convert dollars in gold. In 1971 it openly refused to convert dollars into gold. In other words, dollar is no longer a key currency for general purposes. It cannot be treated as an internationally ‘liquid’ asset at par with gold.

The International Monetary Fund, by international liquidity, means the net gold tranche positions of the different countries with the Fund. The

[1] P.R. Brahmananda, The Gold Money Rush (Bombay, Popular Prakashan, 1969, pp. 12-14.)

'net gold tranche' position confers an automatic and unconditional borrowing right upon the member. However, if the rich countries seek to exercise their rights at the same time, automatic multilateral clearing may potentially not occur and the Fund may be potentially left with excess demand for some currencies and excess supply of others. In other words, the net gold tranche funds may not be as liquid as they appear to be. They may be treated as 'Liquid Assets by chance'.

Thus, from the point of view of international community, however, only that part of such borrowing rights etc., which are capable of automatic multilateral clearance can be considered as international liquidity.

The supply of International Liquidity

Under the gold standard, gold alone constitutes the international liquid reserve, and in the short-period the supply of gold to monetary authority is fixed, for all practical purposes, for the world as a whole.

Under the gold exchange standard, the supplies of liquidity to the world consists of gold plus stocks of key currencies with the non-key currencies. These currencies are held in lieu of gold, though in the expectation that they can be converted into gold, any time this is required. If convertibility is to be possible, the stock of key currencies held as reserves must not be greater than the key currencies stock of gold. Thus, the quantity of gold exchange is quite strictly determined by the gold stocks of the currency-exporting countries. The extent to which the supplies of international reserves in a gold exchange standard exceeds the stock of gold is very much a matter of confidence. At some point, a credibility gap emerges with respect to the key countries' willingness and ability to maintain gold convertibility.

The three Keynesian motives can be applied to international liquidity. We have considered why resources are demanded in varying degrees. If the international community as a whole wants to hold more reserves, the level of price of traded goods will come down. But over the long-run, the supply of reserves will increase as with a given gold price, a fall in goods prices leads to a rise in the real purchasing power. This stimulates more gold production. If the international community seeks to hold less of reserves the price level will rise and gold's real purchasing power comes down. This leads to a reduction in the supply of gold from production sources. We reach the Rueff paradox that gold production goes up at a higher rate when commodity prices are falling than when commodity prices are rising. It is when the propensity to hold reserves is weak that gold production is discouraged and when the propensity is strong that gold production is encouraged. The impact of political factors upon international liquidity is uncertain.

Suggested Readings

1. P.R. Brahmananda : The Gold Money Rift.
 2. Fred Hirsch : Money International.
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INTERNATIONAL MONETARY SYSTEM

- Q Examine some of the major criticisms made against the international monetary system. Or

Examine the various plans for reforming the international monetary system. Or

Briefly discuss the following plans :—

- (a) The Triffin Plan.
- (b) The Angell Plan.
- (c) The Stamp Plan.

Or

Do you agree with this view that the present system has failed to create adequate amount of reserves? What solutions would you present?

Ans. REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Difficulties

The following difficulties have been identified with the working of the present international monetary system and each has at least two aspects :—

- (i) Difficulties with the balance of payments of individual countries,
 - (a) because of excessive deficits or insufficient surpluses in the balance on current account.
 - (b) because of massive international movements of speculative funds.
- (ii) Inadequacy of the growth of monetary reserves,
 - (a) relative to the demand for 'domestic liquidity' or to the 'desirable' supply of domestic money,
 - (b) relative to the growth of foreign trade.

(iii) Fragility of the gold exchange standard

(a) dangerous to key currencies.

(b) dangerous to countries holding large reserves.¹

I. Difficulties with the balance of payments.

The present system has enabled the United States to increase its demand liabilities as parts of monetary reserves of other countries and consequently has postponed the substantial gold outflows from the United States and thus postponed the warning signals which these would have signified. The present system allowed the United States to continue a credit and fiscal policy that was basically incompatible with an appropriate balance on current account. In other words, it gave the U.S. who was facing balance of payments difficulties too much time. Others may charge that the system gives them less time to cope with.

The system, in fact, operates inequitably. It provides inadequate discipline for key currency countries but rather harsh discipline on other countries.

There is agreement that the system should be improved to cope more effectively with speculative capital movements. Massive movements of capital are caused by changes in international interest rate differentials or by rumours of imminent changes in official exchange rates. These were less common before 1914. Hence the gold standard was less exposed to such speculative capital movements. At present the emphasis is more upon maintaining and achieving full employment domestically and low interest rate (even if it leads to outflow of funds) is justified.

2. Inadequacy to International Reserves.

It has contended by Sir Roy Harrod that reserves have grown too slowly during the last ten or twelve years. However, Jacobson, Holtrop etc. deny that either the size of reserves or their rate of increase has been inadequate. Indeed they hold that reserves have been excessive. According to Harrod, inadequacy of reserves relative to the needs of domestic liquidity resulted in deflation and hampered the rate of economic growth. Jacobson regarded the influence as inflationary since it permitted a general rise in the price levels of practically all countries.

Any reduction in the ratio between international reserves and total imports may indicate to some extent that the growth of gold and exchange reserves has been inadequate. The ratio of reserves to imports fell from 81 per cent in 1950 to 50 percent in 1960. This, however, presumes that the need of reserves rises proportionately with foreign trade. Though there may be controversy over this, it is clear that the prospect for future

1. Fritz Machlup, International Economics (London, George Allen and Irwin Ltd., 1964 p. 293).

growth of reserves would be dim if the pool of reserves do not increase substantially. But this is not likely since the further short-term indebtedness of the U.S. is unacceptable to many countries. The only possibility is that international reserve can grow only by means of increased supplies of gold. The latter being inadequate, a real scarcity problem emerges. Changes in the present system are necessary if this scarcity is not to be a fact of life.

3. Danger of Collapse.

The fact that the fast increase of the share of dollar claims on the total reserves of the world may be deemed unbearable for the system has pin-pointed the fragility of the gold exchange standard. Ever since 1950 the United States through its purchases, investments, loans and aid, has put at the disposal of foreign countries more dollars than these countries have used for their purchases in the United States. In this fashion, foreign dollar claims, both of private holders and of central banks and other national monetary authorities, have increased at a fast rate. Earlier the demand for dollars was eager, but later on it declined and dollars were accepted with hesitation.

There were doubts about the value of dollar exchange. In this atmosphere some people talk of increasing the price of gold. This made the position of dollars and preservation of gold exchange standard a difficult proposition. The strong demand for gold for speculative purposes and hedging especially the impatience of holders of dollar deposits and other dollar claims to exchange them into gold, increases the supply of gold. Since not all central banks stood ready to increase their exchange reserves at their expense of their gold stocks, it became necessary for the American authorities to sell gold in order to safeguard the position of dollar. But this involved losses and meant depletion of U.S. reserves of gold and acted as a further reinforcement to the suspicions about dollars. The more the doubts that the gold exchange standard will break down once again (as it did in 1931 when Britain went off gold) the more real becomes the danger of its collapse.

The consequences could be : restrictions on or termination of all sales of gold by the U.S. ; restrictions on the international payments through the introduction of foreign exchange controls and prohibition of capital transfers ; import restrictions of all sorts ; blocking of deposits of foreign nationals ; the end of convertibility of most currencies ; elimination of these key currencies from the official reserves of the central banks and consequently a drastic reduction in liquidity everywhere ; severe losses incurred by those central banks which did not match the depreciation of the key currencies with equal devaluation of their own currencies ; reductions in production and employment resulting from imports restrictions and export reductions. This is hardly a presentable picture. Some improvisations could be adopted, but it would not be wiser to rely upon. The best would be to reform this system.

Suggested Reforms of the International Monetary System.

Fritz Machlup classifies the solution in the following manner :—

- (1) **Extension of the Gold Exchange Standard.**
 - (a) With continuing increase of dollar and sterling reserves ;
 - (b) With adoption of additional key currencies.
- (2) **Mutual Assistance among Central Banks.**
 - (a) With safeguards against expansive credit and fiscal policy.
 - (b) With expansion of domestic credit and expenditures.
- (3) **Centralisation of Monetary Reserves and Reserve Creation.**
 - (a) With overdraft facilities available to deficit countries ;
 - (b) With autonomous reserve creation by the world central bank ;
 - (c) With finance of aid to under-developed countries.
- (4) **Increase in the Price of Gold.**
 - (a) With the gold exchange standard continued;
 - (b) With the gold exchange standard abolished.
- (5) **Freely Flexible Exchange Rates.**
 - (a) In order to make internal monetary policies more independent ;
 - (b) Because monetary policies are too independent¹.

I. Extension of the gold exchange standard.

The present system may continue if people muddle through it. It is expected that confidence in the dollar will be restored, that gold price will not be increased, that the U.S. will restrict its demand liabilities so that other central banks accept them as part of their reserves, that dollar will again be accumulated as foreign reserve, that the new reserves will be adequate for the world's need for reserves. But these expectations may not and did not materialize.

The alternative would be to put the gold exchange standard on a broader base. Some of the strong currencies—German mark, French franc and Swiss franc might be recognized and adopted as additional key currencies, in that other monetary authorities would get used to holding demand deposits in the new key currency countries. The recognition of additional key currencies means not only that the third countries hold reserves in the form of several foreign currencies, but also that the present two key currency countries hold some of their reserves in currencies of the new key currency countries.

1. Fritz Machlup, *International Economics* (London: George Allen and Irwin Ltd., 1964, pp. 299-300)

It is important to understand how, under such a "multiple currency reserve system" official reserves will be affected by international payments. If payments are made from one country to another in the currency of the third country, then and only then, will the effect be precisely as under the full gold standard the paying country will lose reserves and the receiving country will gain reserves, total monetary reserves remaining unchanged.

An explicit proposal for broadening the gold-exchange standard was made by Xenophon Zolotas, Governor of the Bank of Greece, who recommended that the present reserve countries should build up sufficient balances of major, convertible currencies and be used as massed defence in the foreign exchange market and to serve as first line defence of the key currencies. The plan includes a gold guarantee against losses from devaluation and favourable treatment of official foreign depositors.

The Roosa Plan, of 1962 encompasses "more or less continuous holdings by the United States of some moderate amounts of the convertible exchange of various leading countries. The net effect would be to multilateralize a part of the role performed now by the two key currencies within a framework that would place great stress on still further co-operation among monetary authorities. The plan does not include any 'gold guarantees'. The plan uses currency swaps (which imply the reciprocal holding of currencies) and achieve the desired extension, but these (currency swaps) would be a network of bilateral, not multilateral arrangements.

The advocacy of the multiple currency standard is a strange reversal of history. Experience taught the world that safety lay in only an international money. The world, however, is having three international moneys. There are periodic rushes from starting into dollars, from dollars into gold. If three international moneys, supplied from sources independent of one another, are convertible into each other at fixed rates, Gresham's law will operate and the scarcest of money will go into the hoards. If the numbers of key currencies is increased, it can work only if all the issuers of these moneys observe strict discipline in keeping their currency scarce. Even political factors may cause hot money movements out of this and into the other reserve currency and into gold.

To cope with difficulties of this sort, it was proposed that the most important monetary authorities should undertake to hold gold and foreign currencies in fixed proportions. The Postthuma Plan is reported to be behind this idea. In the newer version, the emphasis was upon fixed proportions in which countries have to meet deficits in their payments balance to other countries.

The members of the OECD countries should by agreement fix these proportions for several years to come. According to this plan, all countries (not a few countries) would be treated in the same way. All countries would be in the same measure under the traditional discipline imposed by losses of gold reserves, the losses would be lightened for all, since every

country would be able to cover a part of its deficit with its own liabilities. The addition of these liabilities to the gross reserves of the monetary surplus countries would provide more or regular increases to the monetary reserves of the free world.

The Bernstein Plan restricts the number of reserve currencies to eleven (the currencies of the U.S., Canada, U.K., Japan, Belgium, France, Germany, Italy, the Netherlands, Sweden and Switzerland). He proposes an agreement "among the eleven countries to standardize the composition of their holding of gold and foreign exchange and their use in international settlements with each other." The best way to accomplish this is to establish a Reserve Unit, equivalent to a gold dollar, consisting of a stated proportion of each of the eleven countries, thus a reserve unit might consist of 50% in U.S. currency and lesser amounts in sterling, etc. The proportion of the reserve unit consisting of each currency would be agreed on the basis of its present role as a reserve currency and its importance in international trade and investment. Some consideration should be given to the total reserves of a country, but not to their present composition.

Any country having gold would undertake to hold also a minimum amount of reserve units. Ultimately reserve units would amount to help gold reserves. To create the reserve units each participating country would deposit its own currency with the IMF in an amount equal to its pro rata share of the reserve units to be created. In return each country would be given a credit on the books of the Trustee denominated in reserve units. (Bernstein call the IMF a Trustee and avoids term like International Reserve Bank). Thus the Trustee would hold \$ 3.5 billion in the currencies of the eleven participating countries and they in turn would hold \$ 3.5 billion in reserve units. All currencies held by the fund would be guaranteed against exchange depreciation. The countries would be obligated to convert balances of their currencies, when held by the monetary authorities of the other countries, in gold and reserve units in precise proportions initially 90 : 10, later on 67 : 33 respectively gold and reserve units.

All these plans can succeed provided there is a large measure of confidence in the credit and fiscal policies of the reserve currency countries. The increase of reserves as claim against a particular country implies increasing amounts of credit to the Central Bank of that particular country. This would involve mutual assistance among Central banks of different countries.

2. Mutual Assistance Among Central Banks.

The simplest way of helping another Central bank would be for the helping bank to purchase the currency of the bank in need of help and to continue to hold the acquired foreign exchange for the time being. This can be done either without any previous arrangement or on the basis of stand-by agreements. Of the various which the support action may take, the most favoured calls for loans to the IMF by central banks of surplus countries in their own currencies, enabling the Fund to sell these currencies

to the monetary authority of the deficit country, which pays with its liabilities (and a promise to repurchase these liabilities as soon as possible). The purpose of this support action is to provide compensatory finance to a country suffering from a massive out-flow of short-term capital. [For details see the I.M.F.].

3. Centralisation of Monetary Reserves

The Triffin Plan gains pride of place in this category. It creates new reserves in the form of deposits for the various nations in the XIMF (expanded IMF). The XIMF would create these XIMF deposits by lending to member countries and by undertaking investments in specified securities. The Triffin plan is really a variant of the Keynes' plan for an International Clearing Union presented towards the end of the last war. However, Triffin proposals have been specifically designed to affect a transition from the present system.

The global requirements for reserves can be guessed. It can be a fair assumption that an increase in world trade and capital transactions brings about a concomittant increase in imbalances requiring finances. Triffin emphasises, "I do not believe for an instance, however, in any rigid mechanical connection between such growth rates and the expansion of monetary reserves." Further he adds, "The desirable rates of such increases, however, bear little or no relationship to the resources from which this pool is now most erratically fed."

Triffin suggests a switch from national to international decision-making. In his own words, "The most promising line of approach to a long-term solution of the problem lies in the true internationalisation of the foreign exchange component of the world's international reserves; protecting the world's monetary system from the instability resulting from arbitrary shift from one reserve currency into another or into gold."

The Triffin Plan keeps within the international frame-work of the IMF. His XIMF (expanded IMF) would be very much more an effective decision making body than the IMF is to-day.

There will be a substitution of XIMF balances for national currencies as international reserves. The unit of account is designated as Bancor. A Bancor unit would be equal to a specified amount of gold and each currency's value would be in terms of Bancor.

At the outset each country would be required to acquire XIMF deposits equal to a certain proportion of the country's total reserve holdings (with gold/and foreign exchange). These deposits would be purchased with gold and foreign exchange. Countries would be bound to accept bancor in settlement and could cover deficits by drawing down their bancor deposits. A country that had a bancor deposit greater than the minimum required, could ask for gold or foreign exchange from the XIMF. Thus gold could be purchased from the XIMF.

Triffin also proposes that all pound and dollar holdings should be transferred to the XIMF. These would be gradually liquidated.

Bancor, it is expected, would be preferable to national currencies because of the gold and exchange guarantees affected for it. In the hope of making it preferable to gold interest may be paid on bancor deposits.

Exchange rates would largely be fixed but, as under the IMF, they could be changed under conditions of fundamental disequilibrium.

"The overall pace of reserve creation should be adjusted in such a way as to stimulate a maximum use of the non-inflationary potential for world economic growth. World reserves in Triffin's scheme increase in three ways : (i) gold production, (ii) XIMF credits to deficit countries, (iii) investments in securities. He suggested that the rate of reserve creation be limited to 3.5% a year and that reserve creation in excess of the given figure be subjected to a qualified vote rather than a simple majority vote. The adjustment mechanism would be the same as is under the IMF. This IMF like the proposed XIMF has powers of surveillance and its loans to deficit countries are conditional. It cannot be assumed that XIMF would be more successful in foreign adjustment at the right time and the right pace.

The Angell proposal attempts to meet the gold leak possibility under the Triffin Plan. Angell proposed that gold be used to buy bancor deposits but not vice-versa. Transfers of gold between member countries or between the members and the XIMF would not be required but could only be arranged by mutual agreements. But XIMF members would be required to accept bancor deposits from others in settlement of deficits. Gold would be eliminated except where convenient. The Angell Plan attempted to set out operational criteria to achieve the objections of Keynes and Triffin while moving the world away from dependence on gold.

Basically different from the above was the plan devised by Maxwell Stamp which tied reserve creation to loans for under-developed countries. Stamp would have the IMF distribute certificates (of deposits) to the LDC which would use them to pay for imports from developed countries. The developed countries would use these certificates as reserves and as means of settling balance of payments deficits.

4. The Price of Gold and a Return to Gold.

This school of thought does not regard gold as a barbarous relic but as a useful instrument. According to Jacques Rueff and Sir Roy Harrod, the yellow metal has had an eternal lure for mankind and any plans for reforms should be based on this human instinct. If the price of gold were to be raised, to say \$ 70 per oz. from the present artificially pegged level of \$35 per oz. (last fixed in 1934), the production of gold in the free world (S. Africa) would gain impetus. The sale of gold would be accelerated. The values of the gold reserves held by the U.S. and the U.K. would be enhanced and world liquidity augmented. "If the number of ounces", says Harrod, did not keep pace with the growth of trade,

the value of world reserves might nonetheless help because the value of each ounce tends to rise. Some would advocate a return to the gold standard. In India, P.R. Brahmananda is in favour of a return to gold standard with some modifications introduced.

The basic objections levelled against a revaluation of gold in a number of quarters are :

(i) It results in irrational distribution of liquid assets. The main beneficiaries will be the gold producers and those who hold their reserves mainly in the form of gold.

(ii) The world cannot do with once and for all revaluation. Revaluation will have to be repeated from time to time, thus adding fuel to the inflationary fires.

(iii) It results in a sudden upsurge in liquidity. Liquidity has to grow smoothly along with the requirements of trade and payments but not by leaps and bounds.

There are a number of other gold based proposals. Machlup advocated the systematic lowering of the price of gold over a phased period to eliminate hoarding. The MIYATA-WONNACOTT Plan aimed at eliminating gold speculation by raising the price by small gradations which would be announced before hand to reduce any uncertainty about the future. Under the PIQUET Plan, the U.S. would guarantee the sale of gold at \$ 35 per oz. but not the commitment to buy at this price. Posthuma proposed a maximum 60 percent content of gold in the reserves of industrial countries.

5. Flexible Exchange Rates.

The economists advocating flexible exchange rates form an impressive group—Friedman, Sohmen, Halm, Meade and others. The appeal of flexible exchange rates lies in two directions. First, balance of payments adjustments are automatic. Second, the adjustment takes place without the traumatic changes in prices, incomes and commercial policies needed in a scheme of pegged exchange rates. The band proposal is a variant that allows a widening of the existing of the 2 per cent under the IMF with a wider band, greater interest differentials could be affected thereby allowing more freedom for a country to influence capital movements without altering domestic rates.

Suggested Readings

1. P.R. Brahmananda : The Gold Money Rift
2. Fred Hirsch : Money International
3. Fritz Machlup : International Monetary Economics.

ECONOMIC EFFECTS OF PRIVATE CAPITAL IMPORTS

Q. There has been mixed evidence upon the role of private capital in the economic development of nations, so that a complete analysis of the economic repercussions of capital inflows into the host countries becomes necessary. We may pursue the subject in the following manners :

- (i) Effects on G.N.P., G.D.P. and resource allocation
- (ii) Monetary and price stability
- (ii) The Transfer Problem and the Balance of Payments.

Ans. Resource Allocation, G.D.P. and G.N.P.

Direct investment involves a transfer of personnel, techniques and capital. Additions to the stock of existing technical knowledge in less developed countries help to accelerate the rate of growth. Usually the techniques have been stagnant over a long time, hence a small change in technique leads to considerable change in the production. New advances in science are applied to commercial uses. Foreign firms keep abreast with such attempts made by their parent countries and make full use of their research results. This automatically benefits the less developed countries.

In the beginning, the foreign investment results in an increase in production. If it is accompanied by a reduction in cost, it results in the increase of consumer's surplus. The production of new items leads to significant changes in the demand and expenditure patterns.

Where local resources are exploited mainly by foreign firms, the markets for such resources may function in a manner favouring foreign investment. Foreign corporations may and often do deposit their earnings with foreign banks. The foreign entrepreneur may succeed in obtaining funds at low interest rates in capital scarce economies. He thus earns more than the value of the marginal product where the local entrepreneur may earn less. Gross national product is reduced in

relation to gross domestic product though the latter may not decline in absolute volume.

It depends whether foreign investment will lead to monopoly, concentration of economic power or to a greater competition. Rising shares of the market, high income asset ratios and favourable productivity are likely to result. Generally the high cost marginal producer may be eliminated, but the commercial policies of the host country may save him.

Where resources flow into lines or are subject to utilisation by licensing under patents and trade marks, concentration becomes a definite policy. Part of the patent game is to hide some technical knowledge that is theoretically public. Technical knowledge of the patent is public, but the right to use it is restricted. Without complementary know-how a buyer of patent rights may find his purchases to be worthless.

For the less developed countries it is important that the transfer on non-patented knowledge is taken as a 'package deal' with that of patent rights. The draft resolution submitted to the working group of UNCTAD—II at Delhi recommended that :

Developed countries should encourage and assist the holders of patented and non-patented technology:

(i) to facilitate the transfer to developing countries of technology both patented and non-patented, including new technology, on reasonable terms ;

(ii) to refrain from imposing in the transfer agreements any undue restrictions on exports by the developing countries of the resultant products;

(iii) to refrain from imposing such conditions on the supply of plant and machinery and on the transfer of technical processes as would retard the development of indigenous manufacture and technology ;

(iv) to facilitate the outright purchase by developing countries of technology appropriate to the needs of their countries.

Developing countries, with the assistance, as appropriate, of the developed countries and the United Nations and its specialised agencies, should :

(i) set up appropriate national and regional centres for providing guidance on the technology most suited to the needs of their enterprises;

(ii) whenever possible, purchase technology outright so as to ensure availability and their enterprises ;

(iii) jointly investigate and explore possibilities of outright purchase of licensing of imported technology and patented know-how for the

common needs of their industrial development on a suitable participation basis ;

(iv) associate their scientists and technology from the earliest stages in the process of transfer of technology, so that technology is absorbed within indigenous research and development, and utilised in the most efficient and economic manner ;

(v) exchange scientific and technical information and assist in the transfer inter se of tried out indigenous technology.

The UNDP should give its full support to :

(i) pre-investment activities concerning the transfer of technology as enumerated above, and

(ii) technical assistance on specific requests from the governments of the developing countries.

If the government of this host country provides exclusive tax benefits to foreign investors and protects them unduly from competition, monopoly results. The provision of trade marks often leads to an increase in price as a result of better quality or product differentiation. Even at the higher price level, advertising and other sales promotion techniques may succeed in shifting the demand curve upwards. The method of payment for technical assistance affects the price structure. A royalty based on output tends to be included as a fixed percentage of costs at all output levels. If it is based on sales however, it is deductible from price at different levels. Marginal revenue is affected and also the optimum production level and the price as concentrated to a method where these levels are unchanged. If the return to the over-seas investor is in the shape of a share in profits, price and output decisions will not be directly affected.

In many instances, collaboration agreements are said to hamper exports and the development of an export market for the less developed countries. Exporting from the joint venture in the L.D.C. has a disadvantage of comparative costs with special reference to products requiring skill and technology. There may be competition for the home plant if exports from the developing countries flourish as a result of advantageous transport cost differentials. Profits are measured by sales in sheltered markets—such restrictions take the form of specifying countries to where exports can be made. Foreign subsidiaries may control sale and distribution in importing territories. An extra royalty on export rates is yet another restrictive gimmick. However, where the volume of production is large enough for an export surplus, these restrictions exist more in theory than in practice and are counter balanced by the increase in national product that is generated.

Capital that is imported acts a hiring factor for labour, materials, land and local capital. In theory, resources are drawn away from other employers and the hired factors are exploited to the excess of the value

of the marginal product over the cost to the employers. If, however, factors are hired from a competitive area (particularly with an unlimited supply of labour) the marginal product is not greater than the cost and no exploitation takes place. Simultaneously there might be a rise in real income all around which would benefit the local entrepreneur and the entire economy.

Generally speaking, returns to factors of production are increased and not decreased. The volume of savings increases along with the level of natural income and acting as forces that more than off set any decreased demand for capitals. In the short run, wages may be static as investment becomes capital intensive with increasing profits. In the long run, increased productivity means increased wages. Government and union pressures also tend to keep wages high even with a high level of unemployment. Consequently this wage level of the foreign firms is higher than that of the local firms in the less developed country. As such, modernisation tends to succeed.

Capital, by itself, does not create income. It raises the efficiency of other factors associated in creating these incomes. Capital formation can be responsible only for fraction of the increase in the productivity of labour. If there is no alternative avenue of employing the labour forces released by a technique, the assimilation effect on the labour force is nil. It is generally understood that 'The Big Push' overemphasises the indivisibility problem on both the supply and demand sides.

The "enclave effect" has had disastrous results. Foreign capital in the colonial era moved mainly into the extracting industries and the basic minimum of social overhead activities were provided. Such firms remain an alien sector in the economy. The "backwash" effects come into play without spread effects. In specific sectors the marginal physical productivity of capital is enhanced. But there is no substantial increase in average productivity with structural disequilibrium prevailing at the factor level.

Pecuniary external economies in Scitovsky's sense arise from a greater supply of raw materials, trained labour and the paraphernalia of an infra-structure of roads and hospitals. An increased supply of skilled labour brings in its wake technological economies. The general diversification of activities leads possibly to complementary demand and balanced growth on Nurkse's lines. The diseconomies of scale occur by dominance and the selling of knowledge for a high price. In Pigovian terms the SMP (Social Marginal Product) curve shifts to the right for net external economies and to the left for diseconomies. The PMP (Private Marginal Product) curve is static.

If foreign capital flows into protected industries, profits go up. Profits increase in domestic protected industries and are reduced in those industries where imports have been kept out by protection. Thus 'defensive investment' sets in to maintain a share of the market at average rates of return. Factor prices are reshuffled and capital flows into import replacing lines. In regard to agro-industries the elasticity of supply of foreign capital is low. If exporting had been more profitable then there might have been more

capital. But whether reduced protection would have meant more capital and more exports, is still a question mark. The general protection of imports raises the flow of capital into import substituting lines that are capital intensive. Hence it is argued, that less developed countries should import capital-intensive items unless there are factor reversals.

The "Leontief Paradox" presents itself in the reverse. The LDC are suffering from a scarcity of the factor endowment capital. A pre-occupation with the capital output ratio of the Harrod Doman Model has pervaded all theories of economic development. The low savings are due to a high "dependency ratio"—a ratio of inactive to active population. The catalyst of foreign capital changes the pattern of work—leisure choice. In this framework capital intensive imports may be of advantage as capital output ratio may decrease—less capital per unit of output to overcome the supply bottleneck. Capital intensity may also overcome the shortage of skilled labour.

Monetary and price stability

A direct correlation between capital imports and price and monetary stability (inflation for short run) cannot be postulated. Where foreign capital increases the supply of real goods and services in the short run, i.e., where it flows into quick yielding sectors, the overall result is the curbing of inflationary pressures. The distribution of income will change and even where the real income of the certain recipients suffers a temporary fall, this long run effect of removing supply distortions and increasing supply elasticities will be positive.

However, if capital imports flow into end-product sector where raw materials are still in short supply, the 'linkage' effect is absent. An import surplus develops, incomes are generated and not offset by a flow of goods and services. The classic inflationary gap comes into operation. In such cases, increased current deficits would be the answer by lowering of import duties, changes in exchange rates and restriction of domestic credit expansion. The Latin American countries with highly volatile rates of inflation have been able to absorb large quantum of foreign capital by the simple process of resuming persistent adverse terms of trade with the gap ultimately filled in by official capital from the capital exporters.

Where the host country directs its stabilisation programme in such a manner that imports cover not only the direct cost of projects but also indirect ones (such as maintenance imports) and the increase in home demand as a result of the multiplier effect of investment, inflation can be avoided. If it is possible to channel any supplementary demand into imported commodities, inflation will not occur. The LDC contain a large rural subsistence sector. Higher rewards are necessary to pull this sector with the organised labour market. Thus, some price rises are necessary evils, and the whole macro-economic structure needs to be analysed before drawing any conclusion.

Equity investment is said to have a more stabilising effect on the invested country or it can be adjusted to cyclical fluctuations. In years of depression, dividends could be reduced or eliminated altogether. Portfolio capital carries a fixed interest burden which is aggravated when an economy is down in the dumps. While this was true of the nineteenth century investment, the alleged advantage of equity financing no longer applies. Cyclical fluctuations in recent years have been subjected to corrective action and close control by governments. Their intensity and duration, in general, are less. The advantage of declaring lower dividends no longer looms so large. Thus, the relative attraction of portfolio investment has gone up. The execution of portfolio investment is taking place through public aid. Private portfolio investment has shrunk to very small proportions and any revival appears most likely.

Trade

A shift in resources from labour-intensive to capital-intensive enterprises in the recipient countries will mean a levelling of resource combinations in international trade. The LDC will endeavour to promote the export of processed goods allowing for income and price elasticities of demand. International trade will expand among goods producible in many countries, but made competitive through specialisation and economies of scale. Specialisation in production of separate items within a particular category will supplant industry-wise group specialisation. The relative importance is now attached to scale, techniques of output and demand patterns.

Effects on the potential gain from trade can now be highlighted. First the relative gain from those items not produced in the importing nation—tea from India, machinery from the U.K.—is increased. The gain from easily substitutable items like consumer goods and semidurables is reduced. Any threat of a cut in supplies by a party loses importance as the ratio of a single country's output to aggregate world output is reduced.

Direct investment, will not necessarily move into area of comparative advantage for the host country. Capital imports often flow into import-competing industries as the returns to export industries which are abundant factors are not often high. Government policies stimulate import substitution sacrificing comparative advantage for economies of scale. Where capital does flow into exports, the investor more often than not will change the technical coefficients of production by altering factor supplies and factor payments. The extent of the final gain depends on the item produced and the ability to develop new markets.

Balance of Payments

Under the assumption of constant returns to scale and perfect equilibrium no balance of payments, debt servicing or transfer problem exists. Foreign investment takes place, a trade surplus is maintained by the capital exporting country and is then matched by capital export in the

form of mainly direct ownership of foreign properties. Where capital export takes the form of real goods equal in the value to money capital exported there are no complications. After foreign investment has been effected, there is a reverse flow of real goods to the capital exporting nation to service the capital obligations and this process is perpetual and self-sustaining.

Once unequal factor returns that cause capital exports are taken into consideration, the famous 'Keynes-Ohlin' transfer problem needs analysis. The transfer problem arises from the fact that the income or profits of foreign investor flow back to the investor's country causing strain on the balance of payments of the capital importing country. In keeping with traditional transfer analysis, expenditure in the exporting nation falls and that at home rises by the full amount of the transfer.

Part of the decreased expenditure abroad reduces exports. Part of increased expenditure at home increases imports. The financial transfer is affected in real terms by expenditure changes before balance of payments effects are felt. The exact degree of this fact is dependent on the size of the marginal propensity to spend on import vis-a-vis domestic goods, out of domestic expenditure including the transfer. The general theoretical rules are :

(i) If the marginal propensity to consume domestic goods in the capital importing country exceeds the foreign marginal propensity to import, there will be an excess demand for domestic goods and a surplus balance of payments with domestic prices rising as capital flows in.

(ii) In the converse case demand is shifted away from the domestic to the foreign market, the balance of payments worsens and domestic prices fall with reduced supply of money.

(iii) When the domestic and foreign marginal import propensities are equal, the effects are all neutral.

In some small countries there are extremely large marginal tendencies to import. The adverse effects of a transfer constitute a serious threat. But such high values do not occur in larger countries and the sum of two propensities is not likely to be added to unity. Thus prices in the receiving country may rise. Where receiving countries have low marginal savings propensities and higher multiplier, incomes will be raised by more than the fall in the investing country. The fact that the terms of trade have moved against the LDC leads one to conclude that the reasons for the paradox must be sought in other directions.

In the recipient countries, the demand for imports stems from the internal level of demand apart from the capital inflow. Often, foreign capital flows in when domestic capital is also making a strong bid for a foot-hold. What happens to the balance of payments, therefore is a function of the ratio of internal to external financing of domestic capital formation in the receiving countries.

E. Domar formulated relationship between the return flow of foreign investment and the rate of new lending. He concluded that the return flow need never be greater than the gross out-flows if the rate of growth of new lending exceeded the rate of interest applied to the lending. Private investment alone cannot suffice to cause the new investment rate to exceed the yield. Either the yield rate must be extremely low or the rate of investment too high to fulfil the condition. The remuneration for direct investment varies from 10 to 20 per cent. Hence the transfer burden in the long run is onerous. The short run cost may be less than loan capital as dividends may be lower than interest plus amortisation of the loan. In the long run, loans which fetch 5 per cent are more attractive and can always be 'rolled over'. The resultant savings can counteract cycles more effectively. Even if the flow of loan fluctuates annually, the impact on the ratio of amortization and interest to the total loan is fairly negligible. The comparative advantage of equity investment becomes a mirage.

Kindleberger thinks it a fallacy that foreign lending and borrowings must be continued cumulatively. The interest received by a lender is only partly re-lent. Part is saved. Borrowed capital, if productively used, will cause a shift of recovery among sectors and yield income more than the interest payable. Favourable developments will predominate in due course.

Q. Which are the ways of estimating the requirements of foreign aid? Why should the quantum of international assistance be increased? How is tying of aid secured? Discuss the merits of untied aid. *Or*

“Trade is preferable to aid.” Comment. *Or*
 “The need for external assistance can be reduced if the barriers to trade are removed.” Discuss. *Or*

Point out the difficulties which one faces in evaluating the impact of foreign aid upon the economic development of the recipient countries. *Or*

“If aid is not properly absorbed, it has adverse consequences for the economy *or* of the recipient country”. Discuss. *Or*

Evaluate the impact of foreign aid upon the planned development in India. *Or*

Discuss the courses which India would be forced to pursue if foreign aid were not forthcoming.

Ans. Since the Second World War, the world has become closer and become one in desiring a world order based on peace, prosperity and happiness. The horrors of the Second World War were tremendous according to their times. They have grown in magnitude with the growth of science and technology. Peace becomes the vital necessity but peace is always threatened by poverty anywhere. All people believe that poverty cannot be the destiny of the majority of mankind. Simply belief is not sufficient, realization is ever more necessary. Hence the motivation of foreign aid to achieve this great aim.

Donor countries seek to achieve :

(i) Political impact on international issues in and outside world institutions ;

(ii) certain military and strategic advantage ;

(iii) the promotion of political ideologies such as democracy and communism ;

(iv) to support colonial aims and administration ;

(v) the satisfaction of humanitarian impulses, and the satisfaction of the ego of the nation concerned.

The following basic economic advantages accrue to the aid givers :

(i) It results in the promotion of external trade and steadily growing markets leading to a higher exchange earnings.

(ii) It promotes external investments and consequently increases the national income.

(iii) It achieves fuller employment at home.

(iv) It accelerates economic advance.

(v) It assists in utilizing the advanced technology in a proper way.

(vi) It assists in the increase of markets and thereby assists in gaining from the advantages of large scale product, rather than production.

(vii) It ultimately increases the propensity of the nation.

There are several ways of estimating the requirements of foreign aid. One way is to compare the advanced countries with less developed countries. It has been estimated that the annual increase in the per capita income of the prosperous world is about \$ 40 while the corresponding figure for the less developed countries is \$ 3 dollars. It has also been estimated that less developed countries possess 75 per cent of the world population and enjoy only 15 per cent of the world income. Further, according to estimates since 1958, only one country in the per capita income bracket of \$ 750 or more a year, has undergone a major upheaval, whereas 87 per cent of the countries with per capita income of \$ 100 or less have averaged two major out-breaks.

The United Nations Development Decade (1961—70) also provides an idea about the requirement. It expects that less developed countries will hope to attain a growth rate of 5 per cent, annual growth rate in agriculture of 4 to 5 per cent and an increase in manufacturing output by over 13 per cent, and that the developed countries will provide at least 1 per cent of their combined natural income.

Another method suggested by the United Nations is to estimate capital development needs through capital labour and capital output approach. The former attempted to estimate resources required for purposes of raising the level of employment outside agriculture. The second assumed that increases in production bear a relatively stable ratio to net investment so that given a target rate of increase in production or income, it was possible to derive the figure of net investment required. Assuming a

capital out-put ratio of 2.8 to 1 and an increase of 2 per cent in the per capita incomes, the amount estimated to be created on capital from international source was of the order of 8.5 billion dollars.

The less developed countries have achieved the growth rate of 5 per cent, but if population increase of about 2.4% per cent is subtracted, they have grown at the rate of 2.6 per cent annually. Besides there are great variations in the regions. Agriculture on the whole upto 1966 grew at the average annual rate of 3 per cent while the recommended rate was about 4 to 4.5 per cent. The progress of industry has been mixed. The less developed countries have become the leading importers of primary products, though these were their only major exports earlier.

Another way is the balance of payments technique. Foreign exchange resources are required to the extent that a developing country taking its current as well as capital accounts together is not able to meet the over all gap in its balance of payments position. The aggregate current account deficit for all developing countries was estimated in 1965 to be \$ 6.2 billion. This deficit in essence was the counterpart of a net inflow of official and private capital.

Statistics reveal that the volume of international assistance should be increased for the following considerations :

(i) The absorptive capacity of the less developed nations is continuously increasing.

(ii) Higher incomes of the less developed countries are leading to a increased requirements.

(iii) The less developed world derives an increasing benefit from international intercourse, progressive technology and expanding world market.

(iv) Initially the volume of assistance has to be small so that countries get accustomed to international assistance.

(v) Mutual co-operation expands the capacity of the partners.

(vi) Mutual co-operation leads to a reduction of expenditure on defence.

(vii) Desirable degree of progressivism in matters of international public finance increases with successive, developmental stage of technology and economies.

(viii) It will help in bridging the gulf between the rich and poor nations and thus secure peace.

(ix) It will help in curbing monopoly, concentration of economic powers and other historical factors distorting international economic intercourse.

(x) Most of the industrial economies received external assistance when they were industrialising.

(xi) Modern technology, scientific management and the instruments of higher productivity have grown as a result of the efforts, sometimes consciously, at others not, of the entire world. Its fruits should legitimately be shared by all.

A Bold New Programme.

Increasing quantum of international assistance, in both absolute and relative terms, can be generated, without producing unbearable or politically explosive burdens on the following basis :—

(i) Each country, whether rich or poor, and irrespective of the stages of development through which it is passing, must contribute to a total fund of international assistance whether pooled or not, in accordance with its own per capita income. The range of ratios may vary between $\frac{1}{10}$ to 1 per cent of the G.N.P. for those countries, the per capita income of which is less than, \$ 100, and two per cent of the G.N.P. for countries with per capita income exceeding \$ 2000. The target in each case may be achieved within a period of 5 years.

(ii) Each country should additionally contribute to the total availability of international fund, a sum equivalent to 2 per cent of its national defence budget, which should progressively be increased to 50 per cent in 25 years. It is obvious that each country will enforce reduction in its defence budget corresponding to its increased contribution to the international fund on this account. By this measure, the increasing and large doses of international assistance will not bring additional burden on the people of the lending countries.

These measures suggested at a symposium on foreign aid in 1968 under the auspices of Indian Council of Current Affairs will have the provision of internationalising the assistance. IBRD, IMF, IFC, IDB, Asian Development and other international institutions have been providing international assistance. The linking of defence expenditure to assistance is likely to create the necessary conditions for international peace.

International Private Capital.

International private capital continues to play an important role in contributions to (a) accelerated growth, (b) balanced growth and (c) reduction in socio-economic costs of growth of the developing countries.

The total flow of private capital from the OECD countries to the less developed countries has averaged around \$ 3 billion annually during 1958-1968. While about two-thirds of the total private capital flow is accounted for by direct investments, about 400 per cent of the latter consisted of reinvested earnings.

The outstanding U.S. investments have increased from some 39

billion in 1961 to over 61 billion dollars in 1966. The increase in the four years was about 55 per cent. However, the largest portion of U.S. private capital went to Canada, U.K., W. Germany, West European and Latin American countries. In other words industrially developed countries benefitted most from U.S. capital. On the other hand, the yield was less in industrialised countries and greater in the less developed countries. For instance the yield to U.S. investment in Canada and Europe was 7.4 and 7.1 per cent while it was 28.9 and 52.4 per cent in case of Asia and Middle East.

However, these high returns may not be repatriable. This will discourage the U.S. investor to invest in the less developed countries. Besides, the risks of war, non-convertibility and expropriation have grown greater as the less developed countries have become desperate in achieving higher rate of growth. Some attempts have been made to remove or reduce these risks. The United States and West Germany sponsored schemes for guarantees covering repatriation of capital and profits invested by their respective nationals in other countries. The United States investment guarantee scheme gives protection against the risks of war, expropriation and non-convertibility. The I.B.R.D. has been making efforts in this direction.

Aid Vs Trade

One very effective way of reducing the need for external assistance is to reduce and eventually remove the barriers to trade, in the forms of tariff, quantitative quotas, exchange restrictions.

External assistance is a stop gap measure. It pulls the economy out of stagnation. It creates additional purchasing power, helps to raise the investment and consumption levels and thus creates a more extensive market for the products of the advanced nations. But it cannot be a permanent feature. It cannot supplant normal economic relationships and trade conditions. If it is used too much, it increases economic burden on the world community. It undermines the fuller operation of the law of comparative advantage. It intensifies and creates new political tensions and frictions.

The world trade in 1965 increased by over 200 per cent over 1948 and reached the figure of 164 billion dollars. This presumed that external assistance had provided this necessary purchasing power to developing countries by the modern sophisticated products of advanced economies. The World Bank Report realizes that "improvements in world markets for export from developing countries will be a critical factor for economic development."

The world increased its exports from 1948 to 1965 by 209 per cent. The developing countries could achieve only a 120 per cent increase in their exports. Their share of the world trade declined from 30.74 per cent to 21.43 per cent in the same period. Obviously the increase in world exports was accounted by the industrially advanced countries of Europe.

Thus the developing countries back the purchasing power (it has been rapidly declining) to purchase the increasing volume of goods from the industrially advanced countries. If restrictions of all types are removed by the developed countries, it will result in increased exports from developing countries. The latter will experience higher level of income and consequently import increasing amounts from the advanced countries. Thus it is in the interest of the advanced countries that trade restrictions are liberalized.

With increasing demands generated directly as a result of population growth and an attempt to achieve faster economic growth, developing countries have been confronted with large deficits in trade and payments balances. The more disquieting feature is not the deficit but its increasing volume. Imports of Africa, South Asia and Southern Europe and Middle East have been rising more rapidly than exports from these countries. The average deficit in the trade balance of developing countries has been of the order of 4 billion dollars per year between 1960 and 1966. The deficits were of the order of 10 to 17 per cent of the exports and varied from year to year.

Despite widespread emphasis on the expansion of intra-regional trade among developing countries, such expansion of trade has also not exceeded the growth of total exports. The relatively slow growth in the export trade of developing countries reflects their heavy dependence on primary products. In volume, their sales of these commodities increased by 5.5 per cent per year during 1960-65, as against an expansion of 9.5 per cent per year in the export volume of manufactured goods. Exports of petroleum and petroleum products grew by some 11 per cent while all other primary products combined increased in volume by only 4 to 5 per cent.

In the Middle East and East Asia, the rate of increase in imports was very close to the growth rate of G.D.P. In both South Asia and Africa where GDP growth was relatively low, imports rose faster than G.D.P. Only in Latin America did imports increase in 1960 at a lower rate than GDP, partly because of balance of payments difficulties and partly as a result of import substitution.

Promotion of trade of the developing countries needs positive encouragement. The progress so far, despite the GATT, UNCTAD, and Kennedy Fund etc. has been halting and disappointing.

The first UNCTAD recommended trade concessions to developing countries on a non-reciprocal basis. The Kennedy Fund might have benefitted all countries in the same way as it is representative of a better-out-work on the part of the developed countries.

Many suggestions, made at the UNCTAD, not supported by all, include :

- (i) There should be international agreements to stabilize commodity

prices, as 88 per cent of export earnings of developing countries accrue from exports of primary commodities.

(ii) Differential tariffs on primary products should be removed.

(iii) Developed nations should give general preferential treatment to the import from developing countries.

(iv) A programme for this total elimination of all quantitative restrictions as exports from developing countries should be designed.

(v) Trade with socialist countries should be encouraged and made more flexible than presently.

(vi) Barriers to trade in developed countries should be so removed that the developing countries could compete freely in the domestic markets of the former.

(vii) A set of norms should be adopted to guide negotiation for a system of preferences to developing countries.

(viii) General preferences should be so absorbed eventually in the normal international trade that these do not result in fragmentation of international commerce.

(ix) Diversification of exports from developing countries should be promoted.

(x) Revenue preferences to industrial countries in existing regional or political frame work should be eliminated in favour of general preferences to the developing countries.

(xi) The schedule for implementation of Kennedy Fund Agreements should be shortened.

(xii) Supplementary finances should be made available to meet current deficits in balance of payments of developing countries.

(xiii) There should be a concerted action to organize commodity market with the acceptance of a code of discipline by developing countries with regard to the quantities produced.

(xiv) There should be a general agreement on commodity arrangements as developed by the UNCTAD Secretariate.

(xv) Products, which were ready for international arrangements, should be identified.

(xvi) A scheme of payments arrangements should be evolved to provide financial support for the promotion of trade exchanges amongst the developing countries as a whole.

(xvii) A fund should be created for placing natural products on a more sound basis in the context of the threat posed by the rapid development of synthetic products.

(xviii) Joint efforts should be made by primary producing countries for financing a scheme of buffer stock and diversification of export trade of the developing countries.

(xix) A specific scheme under the auspices of the UNCTAD should be established for underwriting in initial years, losses of shipping lines operating between developing countries.

(xx) Regionalisation of world trade through group formation should be discouraged.

Tying of Aid

The increasing distrust between the advanced industrial countries and less development countries on political grounds and on increasing tendency on the part of developed nations to concentrate their attention on their narrow partisan interests, has resulted in tying of aid. The implication is : aid is not without conditions. The recipient countries have to toe the line of the donor countries. If they do not, they forgo the aid.

There are various ways of securing the tying of aid, such as

- (i) by release of non-convertible currencies;
- (ii) by restricting procurement from the lending country;
- (iii) by projectisation or itemisation of assistance, such as by way of permitting deferred credits or granting loan for specific projects ;
- (iv) by restricting the repayment in specific currencies ;
- (v) by imposing other restrictions such as the use of feed stocks or technology of the lending country or participation by nationals of the lending country ; and
- (vi) by restricting the markets. Besides generally tied aid has to be repaid in free foreign exchange. This further increases the cost of assistance.

From the point of view of the receiving country untied aid has great advantage. It enables the receiving country to use it for purchasing investment goods from the cheapest market. Tied assistance reduces the value of assistance in real terms. The American aid was less tied in the fifties. In recent years, all American economic assistance is tied. It is commonly felt that U.S. machinery and equipment has been more expensive by about 5 to 20 per cent as compared to European and 10 to 25 per cent as compared to Japanese. In many cases of international procurement, most of the competitors have to lose the contracts only because financing facilities from their countries are either not available, or if available, they do not match the terms. It seriously reduces the international competition in global tenders of procurement. The U.S.A. has equally by financing its exports on the most favourable terms. This is an additional element which changes the economic assistance to financing of export trade.

Similarly the assistance from the Soviet-block countries is fully tied. Since the repayment is often tied too, it makes it more attractive to the developing countries. Tying of aid increases the costs of procurement of imports. Besides it distorts international trade. The World Bank Report for 1966-67 recorded, "The difference to the borrowing country in the purchasing power between tied and untied assistance can be considerable. Since most of bilateral assistance is tied, diversion towards multilateral assistance should be encouraged.

Certain other conditions raise the cost of development. The Americans insisted on controlling the management of industrial enterprises which were lent out of PL 480 funds. This poses the question whether assistance is meant for the nationals of the developed country or it is meant for the developing countries. However, in the beginning of industrialisation, project tied aid should be welcome. Project aid cannot be misused and can be evaluated by its results. It reduces interjection of extra economic factors.

Double tying may occur when aid is both project and procurement tied. Donors double-tie to make it more certain that aid will reduce extra demand for their goods. With procurement aid tied for programmes, a recipient can select those commodities he would buy from the donor in any case. Double tying makes such selection more difficult, since it is unlikely that a single donor will be the cheapest supplier of all the goods required for a project. Hence international trade is distorted more in double tying.

ECONOMIC IMPACT OF FOREIGN AID

It is very difficult to evaluate the impact of aid upon the economic development of the recipient countries because of following variables :

- (i) volume and proportion of assistance to total investment ;
- (ii) nature of assistance, whether tied or untied, and whether it is repayable in the currency of the recipient country or in free foreign exchange ;
- (iii) kind of assistance, whether it is a loan, supplier's credits, grant of return yielding capital;
- (iv) objectives of assistance, whether it is applied for procurement of raw materials, maintenance imports, equipment or technical know-how and expertise or for servicing debts;
- (v) capital out-put ratio of the programme to which assistance is applied;
- (vi) political and natural factors.

A larger per capita foreign assistance has been primarily responsible for a rapid rate of economic growth in Taiwan. Similarly a larger volume

of foreign aid per capita has enabled even Malayasia and Pakistan to develop at a faster pace than India. In short, a higher proportion of foreign aid per capita with the same rate of domestic savings helps a country to accumulate a much greater amount of capital assets and this cannot but accelerate the rate of economic growth.

However, no positive correlation has been found of savings and investment, imports and exports with economic assistance. On the other hand, Taiwan, Israel and Greece have increased their economic growth along with reducing their dependence on foreign aid.

External economic assistance has been used largely for building infrastructure. It consequently exercises a multiplier impact on the growth of the economy. External economic assistance in a particular sector is not a reliable and adequate index of general economic growth. However, creation of productive facility can be qualified in terms of capacity created, investment made, capital formation, income generated, employment provided, repayment burden. Qualitative aspects of foreign aid are difficult to measure.

The impact of international assistance may be evaluated in terms of several indices indicating accomplishment areas of predetermined objectives in different areas of economic activity, such as

- (i) a fair rate of investment growth ;
- (ii) a fair increase in G.N.P. and per capita incomes ;
- (iii) a fair increase in the proportion of the contribution of manufacturing industry to G.N.P.;
- (iv) stability in prices ;
- (v) a fair rate of growth of exports ;
- (vi) a manageable balance in external payments situation ; and
- (vii) an absence of undue pressures on debt amortisation and other service payments.

A study of the working of economies of Israel, Mexico, Taiwan and Yugoslavia, shows that adequate economic assistance along with favourable circumstances, effective policies and national determination, results in a rapid rate of economic growth. The effectiveness of aid is a function of its correspondence with the plan of economic development of the recipient country.

In this connection we should note that if aid is not properly absorbed, it has adverse consequences for the economy of the recipient country :

- (a) The recipient country loses its self reliant character and approach towards development ;
- (b) The immediate costs of development are increased ;

- (c) Unbearable burdens on repayment capacity are imposed.
- (d) The recipient country becomes subordinate to the lender country.
- (e) The natural international relationships are distorted.
- (f) International tensions are reinforced.
- (g) Indigenous resources fail to be exploited and utilized fully.
- (h) Indigenous development of technology is discouraged.
- (i) Waste and insufficient utilisation of resources is encouraged.

If misdirection of aid and the consequent adverse effects of aid are to be avoided, the recipient country should :

- (i) develop and adopt a programme of economic development and the volume of external assistance necessary to achieve its objectives ;
- (ii) ensure efficient utilisation of resources both external and domestic;
- (iii) follow a policy enabling it to make full use of available resources;
- (iv) ensure non-discriminating treatment to external resources ;
- (v) fulfil its international commitments ;
- (vi) mobilize domestic resources to match the external resources ;
- (vii) should subject its activities to effective economic discipline which should maintain proper structural and operational balances in the economy ;
- (viii) ensure political stability ;
- (ix) show that it does possess the repayment capacity to meet its obligations.

THE IMPACT OF FOREIGN AID ON INDIAN ECONOMIC DEVELOPMENT

India contains 30 per cent of world population. India received in 1963 \$ 2.1 per capita from OFCD countries and multilateral agencies, while Pakistan received \$ 6.0 in 1964 from the same sources. Pakistan's population was about $\frac{1}{5}$ of India during the same period, but aid per head was 3 times greater. It should work out about 15 times difference between the two nations.

This is despite the fact that India should be given the topmost attention on any criteria. She is one of the poorest countries. Her development potential is high. She possesses an efficient administration, a high level of education and skills and a reserve of potential entrepreneurship. Its plans are well conceived and she has applied stringent import controls and high level of domestic taxation. She does not face a structural balance of payments problem and possesses considerable absorptive capacity. She possesses constitutional democracy. On all arguments India qualifies for large aid.

Aid adds to the total resources available to the community. It may be used to raise consumption, private investment, or government expenditure. In general, the value of aid to India is equal to the value of these additions. Now, aid further helps to break a bottleneck—foreign exchange, particular items of equipment, or particular skills, the value of aid exceeds the nominal value of aid given. It helps to utilize fully capacities in other sectors of the economy. However, an aid-financed project imposes a burden of recurrent or other contributory expenditure on the domestic economy, and that these resources could have been used more productively in other lines. In such conditions the value of aid to India falls short of its nominal value. Again, to the extent, aid is available in free spendable foreign exchange, its value is likely to exceed its nominal value. Similarly, the string of aid restricts its value over nominal value.

The convention approach to analysing the impact of aid is to regard it as filling either of two gaps, depending upon which it is larger. If growth is seen as a function of the ratio of investment to national income, aid is seen as filling the gap between target investment and domestic savings. Alternatively growth is regarded as constrained by foreign exchange, aid fills the gap between the foreign exchange required to achieve a given growth target, and the foreign exchange earned by visible and invisible exports plus private capital flows.

The weakness of the double gap approach is that it makes assumptions, sometimes justified in advanced economies, which are unwarranted for India. The saving gap approach assumes that the relationship between investment and additional output is fairly stable, and consumption makes no contribution to output, and that home and foreign savings are interchangeable. But in the diagnosis of India it is normal to assume that the dominant bottle-neck is not saving, but foreign exchange. There have been several cases in which potential domestic savings have run to waste for lack of foreign exchange. Aid requirements, therefore, tend to be approached through the trade gap. This analysis assumes that growth of domestic production could be accelerated with more foreign exchange.

Contribution of external finance to public plan outlay is lesser in 4th plan compared to 3rd Plan if the fall in money brought about by devaluation is taken into account. Without aid, India would have increased its tax efforts, as she has shown since the Bangla Desh crisis.

Now, in case, aid had not been provided, four courses would have been opened from the foreign exchange point of view: non-development imports retardation, development import substitution, export expansion, and a shift of plan outlay into areas with low foreign exchange requirements. Since the foreign exchange crisis of 1957-58 India has imposed the most stringent controls on imports of consumer goods. Figures indicate that of food grains, 82 percent of which consists of PL 480 imports, are excluded, the total value of consumer goods imports was lower in the 3rd Plan than in the First. Little foreign exchange can be gained by further restrictions of consumption imports. As for the second course,

development import substitution, raw materials and equipment are closely scrutinized for possible indigenous replacement. In any case, import substitution of equipment requires, in the initial stages, larger, not smaller imports. It is the strenuous attempt to set up domestic import substituting capital goods industries which is responsible for the growth of raw material and capital imports.

There has been considerable increased capacity in Indian industry as a result of inadequate imports of raw materials, component and spare parts. A change in the composition of imports—a higher proportion of maintenance imports and a lower proportion of imports tied to new industrial capacity—would indeed lead to higher capacity utilisation. But there is little scope for substituting domestic production for imports in such a way as to reduce import requirements substantially in the near future.

Export expansion, unaccompanied by an equivalent fall in unit prices of exports, is the third way of reducing dependence on aid. Indian exports stagnated during the first and second Plans. They rose between 1960 and 1964-65, subsided upto 1970 and have risen since then. However, traditional exports (tea, jute and cotton) run into limitations of demand, and non-traditional exports, though they showed impressive increases, a still small proportion of the total. Exports of engineering goods, iron ore and steel, and chemicals form about 10 per cent of total exports. These exports need to be pushed up, but foreign exchange will be required to build up this export potential.

The fourth method of saving foreign exchange is to change the composition of plan outlay in the direction of economising in foreign trade. More emphasis on agricultural growth would have required greater imports of fertiliser's machinery if fertiliser's plants were to be built up.

We conclude that added foreign exchange shortages would have led to ever more severe cuts in the second and third plans, even if domestic savings had been available. Furthermore, even if foreign exchange had been available, size of the plans could have been hardly maintained with the mobilization of resources. What follows that reduction in the plan would have been greater than the aid provided. In other words, additional aid helped India to mobilize a multiple account of resources provided by the aid.

Thus even if some administrative faults are admitted, India can absorb substantially more aid than it receives now. If more aid is provided especially in the fertiliser industry, and proper implementation is assured, it is believed by Western authors, that productivities of aid in India will rise and would lead to a fuller utilisation of existing capacity raising output indirectly. The need for physical controls would be reduced and higher productivity would be ensured. We have to assume that agriculture continues to grow at a rapid pace and makes India self-sufficient.

New Initiations

Several new suggestions are recommended :

(i) The Late John Stratchey proposed a scheme by which India and Britain would agree to identify specific markets in each country to be supplied by the other.

(ii) Aid from surplus capacity should be encouraged.

(iii) India could find out about using the second hand equipment provided maintenance costs do not shoot up.

(iv) Value of aid could be considerably increased if it was planned for long-term in advance.

(v) The idea of setting up joint enterprises is worth studying. This would increase earnings and allow more markets to be captured and thus result in increased exports.

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INDIA'S FOREIGN TRADE

Q. Trace the pattern of export trade during the planning era in India.

Or

How far can India go for import substitution ?

Or

“The foreign trade planning under the disintegrated world orders must strive to eliminate the imbalance between the rate of growth of exports and the propensity to import so as to avoid the detrimental effects on the rate of growth”. Discuss, in this context, the strategy of foreign trade planning in the 4th Plan.

Or

Analyse the trends in India's trade with less developed countries and countries of Socialist Block.

Ans. Observers note a change in Indian outlook towards foreign trade during the planned period. The first two plans paid relatively little attention to export expansion. Emphasis was on seeking foreign aid to accommodate rising imports. The Third Plan represented a slight change. The emphasis was switched to import substitution. However, it is only during the 4th Plan, that the objective of export expansion became dominant in achieving the necessary external equilibrium.

Throughout the plan period, imports have grown more rapidly than exports. Thus the trade gap has increased continuously. The Second Plan witnessed the sharp expansion of imports as the rapid industrialisation raised country's demand for equipment and as a more liberal import policy was followed in the early years of the plan. The exports, however, fail to register any corresponding increase during the first two plans.

At the time of the formulation of the Third Plan, imports were expected to increase by about 16 per cent. By then, production of essential products and improvements in the infra-structure of the economy were such that it was reasonable to expect a reduction in the direct foreign exchange component of investment from 30 per cent in the Second Plan to 20 per cent in the Third.

In the event, total imports were 6 per cent less than anticipated, although food imports under PL-480 (Rs. 8,500 million) were higher than expected. Unfortunately, the short fall in imports did not reflect increased self-sufficiency or efficiency in the Indian economy, but simply the drastic reductions in various import quotas in 1962-63, made imperative by the serious state of the current balance of payments.

Though the performance of export during the First and Second Plan was marginal, a brighter performance was expected in the 3rd Plan as they were expected to reach Rs. 37,000 million and Rs. 38,000 million. The increase in relation to the Second Plan was about 20 per cent. Infact, total exports exceeded the plan target and reached Rs. 38,120 million. However, the progress was not sustained. Exports increased considerably between 1961 and 1963 but declined in 1965-66. The decline could have been caused by a series of rainless years and a hot war with Pakistan.

The encouraging developments in the pattern of export trade during the 3rd Plan may be noted : (a) Indian exports were slightly less concentrated in traditional exports. The share of three traditional exports—tea, cotton textiles and jute manufactures—in India's export trade declined from 48 per cent in 1960-61 to 43 per cent in 1965-66 ; (b) Exports of engineering and chemical products still accounted for less than 4 per cent of all exports in 1965-66, but in this period was over twice as large as their share in 1960-61. The share of Iron and steel products had also risen. A number of products in the light engineering sector appeared for the first time as exports ; by the end of the period India was exporting a wide range of 'light' manufactured goods, such as type-writers, plastic goods and fountain pens.

As regards the geographical pattern of trade, the United Kingdom accounts for a steadily diminishing share of Indian exports, 18.1 per cent in 1965-66 against 26.8 per cent in 1960-61. This may be regarded as a healthy development since Britain's entry to E.C.M. is a fact of life. The United States' share of Indian exports registered an increase from 16 per cent in 1960-61 to 18.3 per cent in 1965-56. The most dramatic change took place with regard to the share of East Europe in India's exports. The countries of Eastern Europe increased their share from 7.7 per cent in 1960-61 to 19.3 per cent in 1965-6. Similarly the exports to the Soviet Union rose sharply from 4.5 per cent in 1960-61 to 11.5 per cent in 1965-66. The increased importance of Eastern Europe and Soviet Union is evident if India is to attain rapid strides in export promotion.

Some observers have noted that Indian exports in quantities for necessary imports to Eastern Europe and Soviet Union are re-exported to the Western countries at lower price in order to obtain convertible currencies. These goods compete with goods exported from India directly at competitive price and reduce his foreign exchange earnings. This practice is alleged, to be prevalent in engineering goods.

THE STRATEGY OF FOREIGN TRADE PLANNING AND THE 4th PLAN

Mr. S. C. Nandwani, in his book "Trade Dilemma of Developing Countries" notes that favourable climate does not exist for expanding the exports of either traditional or new goods. The solution to the problems can be traced only if the developed countries through some UNCTAD agreements come to accept unilaterally the import of some of the products of the developing countries, of which there seem to be little chances. Developed countries are rather reluctant to part with any of their trade gains without reciprocal dumping of their commodities.

Trade relations among the developing countries themselves shall have to be enlarged in spite of the formidable obstructions. Developing countries can export some of the producer goods, if they have acquired the necessary technique for producing such goods. The investment for this purpose should, however, be correlated to the need for import substitution and efforts should be made to see that thereby they not only feed their home markets, but also compete in the foreign markets. But it is rather difficult to carry out such a comprehensive programme without proper planning.

The alternative to enlarging the capacity to import is that these countries should make the best and the most rational use of the existing capacity to import. It comes to having a rigid control over foreign trade. Various organisational steps may have to be taken to bring it under regulation. Import policies should be formulated in close relation with the over all plan. It calls for radical measures on the part of such governments to strictly control the consumption by the privileged classes. Under the circumstances, internal economy has to be protected against foreign influences and safeguarded from foreign exploitation, foreign trade has to be, of necessity, more or less, a State monopoly. The governments will have to handle all the imports and set the prices for them. It will also help in the proper allocation of some selected goods in short supply. But it calls for the much needed efficiency, which the government machinery in a developing country generally lacks. Effective government control will also enable to subsidize exports and use exports and imports as important instruments of fiscal policy and hence helps in the capital formation of the country. Thus organisational improvements can do a lot in stepping up the effectiveness of foreign trade. But this has its limits. So we should lay more stress on improving the volume of exports and our capacity to import. It is also necessary to start producing commodities vital for import substitution.

Import Substitution

Import substitution implies, producing for the home market products which are imported from abroad. There is immense scope for import substitution not only in manufactured goods but also in raw materials and primary products. The stage for import substitution is set when a developing country is in a position to make substantial exports. And it

is a continuous process without substantial limitations. The developing countries should give purposeful direction to their development efforts by promoting import substitution industries at low levels of development, the developing countries should start with agricultural commodities and raw material. Of course the country should specialize in commodities in which it has a geographical advantage. And later on with the fully developed technique can take over the whole of anti-import production.

As to the process of substitution, it depends on the individual country's level of development. In general, import substitution industries are to be preferred to export oriented industries in an import sensitive economy. And when it comes to a choice between the import substitution and export oriented industries, the former will have to be given precedence over the latter, given the investment outlay for the two, primarily because they will go to strengthen the economic sovereignty of the country and more so they reduce the uncertainty, which the export oriented industries would face, being always dependent on external market conditions. But in determining priorities for import substitution, one has to take into consideration the stage of development and economic structure of the country.

All the developing countries are not capable of starting import substitution industries. Many developing countries are so small that heavy industry cannot possibly stand on its own domestic demand in the long run. And this will not be economical from the point of view of their development. Some major countries like India, may successfully implement such programmes.

In conclusion we can say that foreign trade planning under the disintegrated world order must strive to eliminate the imbalance between the rate of growth of exports and the propensity to import so as to avoid the detrimental effects on the rate of economic growth. The exports have to be enlarged at low levels of development and when the economy attains a specific stage of industrialisation, efforts should be made to reduce the propensity to import through import substitution and other institutional changes within the country. But for the rapid rate of growth of economy we have to rely not only on import substitution but also to a large extent on export promotion.

However, the task seems to present formidable difficulties. Added to it is the increasing divergence of standards of living. The developing countries are almost stagnating in economic growth, while their counterparts, the developed countries are increasing their output more than before. The widening gulf in the standards of living is not only the sad legacy of colonial days but constitutes a permanent threat to the developing nations. It enforces on the developing countries the traditional pattern of trade and hampers their industrialisation programmes. Under the existing circumstances developing countries find it difficult to implement either the programme of export promotion or import substitution. And the lack of real capital makes it impossible to fully utilize the resources of the country.

Thus the solution of the problem lies in massive flow of capital without any restriction to the developing world. An integrated economic development of the world at large, would be the only hope of developing countries.

However, such an integrated development of the world at large is far away and similarly the massive flow of capital without restrictions does not seem to become a reality in the near future. Rather, as we have seen earlier, the developing countries including India, are increasingly witnessing the reduction of foreign capital. This is an unhealthy development and calls for a slightly different approach more attuned to self-sufficiency. India, particularly, feels the need of such an approach.

The "Fourth Five Year Plan" records that the balance of foreign exchange requirement amounting to Rs. 8,300 crores will have to be met out by export earnings. This is significant for it clearly puts the burden of financing on exports. The export earnings must increase from 1,340 crores in 1968-69 to Rs. 1900 crores in 1973-74 or at a compound rate of 7 per cent per annum. This rate of growth does not appear to be beyond reach if proper reorientation in policies and institutional arrangements for export promotion is thought about.

Further the document points to the need for stability of policies pursued for export promotion. However, there should be a degree of flexibility to permit adjustments according to fresh developments.

The document lists the policies : The policy measures, in the first instance, have to be designed to increase the availability of goods for exports. This will call for measures to expand the production base for exports as well as restrain increases in domestic consumption of exportable goods. Fresh investments in export oriented industries and adequate and regular supply inputs of right specifications will have to be arranged from domestic or foreign sources. Investigation may also have to be undertaken to identify new types or varieties of exportable agricultural products and inducements given to increase their supply and exports. Programmes for research and market surveys may be necessary to find new uses and new markets for traditional items.

"Attention needs to be given to the improvement of efficiency and lowering of costs of production specially of non-traditional items. Encouragement should be given to exports with high potential for growth and good prospect of competing in international markets. Adjustments in export duties as also full refund of or exemption from excise duties should be made where appropriate. In the case of traditional items like cotton textiles and jute, facilities are required for mobilisation and rehabilitation of manufacturing units. Replantation of tea bushes and modernisation of processing and package facilities would be necessary to promote tea exports.

For a larger export of non-traditional items like iron ore and engineering goods, improved transport, handling and berth facilities at

ports, wider publicity and adequate after sales service will have to be provided. Developing countries may also require technical and financial assistance including deferred payment arrangements along with machinery and equipment exported under contracts on turn-key basis, while restricting imports to the minimum, essential supplies of imported raw materials and components should be assured to the exporters. Other facilities needed by exporters should be extended in full measure."

The Report estimates the prospects of export over a long period upto 1980. It states, "The growth of our major traditional exports, and in particular, tin, jute and cotton textiles, is likely to be slow. The major direction of future diversification will be in metals and metal manufactures (including machinery, equipment and engineering goods) iron ore, chemical and allied products. The world demand for these has been growing, and will continue to grow, at a much faster rate than for most other items. India, with its wide industrial base, which will be further strengthened and expanded as a result of the programme of development, should be in a position to take advantage of the growing trade opportunities in this range of products as competitive basis. Of the projected increase in commodity exports, it is postulated that nearly 65 per cent would be detained by the expansion of trade in minerals and manufactures. The share of tea and jute manufactures, two of India's major traditional export items, is expected to be reduced from 29 per cent of total export in 1968-69 to 17 per cent in 1980-81. The relatively rapid growth of demand for oil cakes and fish and fish preparations in the world market, however, offers a promising avenue for expansion. It is also possible that, as the supplies of food grains improves and self-sufficiency attained, an increasing amount of superior qualities of rice could be diverted for export purposes."¹

India and The Less Developed Countries : Trends in Trade

The developed nations have tended to trade among themselves through the regional grouping like EEC, EFTA and COMECON. Their trade with less developed countries has not increased in the proportion as the world trade has increased. Consequently the less developed countries have suffered. As a way out they have been more interested in expanding trade among themselves through regional organisations like LAFTA—Latin American Free Trade Association and Central American Common Market, and bilateral trade agreements.

The results are yet to be decisive. For instance, trade among the less developed countries declined from 6.6 per cent in 1965 to 4.9 per cent in 1966 as a proportion of world trade, and was mainly confined to the States of neighbouring geographical contiguity. The reasons seem to be ; the preponderance of primary products and traditional exports, trade restrictions among the LDC, and tariff negotiations being carried on mainly

1. The Fourth Five Year Plan, pp. 40-41.

with developed economies with whom the nations were bound by historical ties—France with her former colonies, Britain with South Asia, the United States with the Latin Hemisphere.

Indian exports to the less developed countries stood at a figure of approximately \$ 1600 million. Exports, however rose in 1968 by about Rs. 2.8 crores to Africa, though declined to the U.A.R. by about 70 lakhs. Exports to Japan were higher by Rs. 5.8 crores mainly because of higher exports of iron ore and iron and steel. A few trends can be observed :

(i) The proportion of minor exports has increased. For the first time salt has been exported to Africa, electrical appliances to Guinea, bicycles to Syria and diesel engines to Iraq and Cyprus. Export orders for cables worth Rs. 2.7 crores and 80 lakhs respectively were received from Kuwait and Singapore in addition to a Rs. 7 crore order from Nigeria for transmission cables. Similarly Iran has placed a Rs. 2 crore order for joints while Malaysia and South Korea have placed orders for hydraulic gears and wagons respectively. Thus the export of non-traditional items seems to increase. However, the Indian share in the imports of many developing countries is still small, being 2 per cent of Malaysia, 7 per cent of Thailand and 3.8 per cent of Burma's.

(ii) Indo-U.A.R. trade has seen ups and downs despite the agreements of co-operation and preferential arrangements. Indian exports in 1967-68 were 50 per cent of expected exports and amounted to about Rs. 20 crores. Egypt reduced her imports of all commodities. Indian imports of Egyptian rice have been hampered by high Egyptian prices, thus, self-interest has dominated negotiations to the detriment of long run trade liberalisation. India and the U.A.R. have agreed to co-operate in the production of tractors, diesel engines, oil products, ships, fertilisers, phosphates and hydraulic equipment. Yugoslavia will also participate rendering the agreement a Tripartite basis. Sectoral group for these six sectors of industry will work and devise ways and means of closer co-operation.

(iii) The Indian exports to Turkey declined from 5.19 crores in 1962-63 to 35 lakhs in 1966-67, while Indian imports declined and were only 2 lakhs in 1966-67. The adverse trend can be explained. Turkish discrimination in favour of Pakistani Jute, the high price of Turkish sugar. India could look forward to better prospects in respect of steel exports.

(iv) India has had a favourable balance of trade with Ceylon. Indian exports include a large variety of consumer goods, while her imports are restricted to copra, coconut oil and rubber. Pakistan and China have captured the market for chillies from India in Ceylon. While Indian exports have stood about 19 crores, her imports from Ceylon have declined from Rs. 5.3 crores to 3.7 crores in between 1963 and 1968. India has offered a credit of Rs. 5 crores for purchasing from India machinery and machine tools. Indian technical assistance to Ceylon under the Colombo Plan has amounted to about Rs. 1.27 crores.

India signed first agreement with Philippines in March 1968 which listed the goods that India could export.

(v) India has accorded most favoured nation treatment to Mangolia in a trade agreement signed in 1968. Payment is expected to be convertible currencies otherwise agreed to. Clearing accounts are permissible. Exports envisaged from India to Mangolia are items like tea, tobacco, vegetable oil, chemicals, tarpaulins and pharmaceuticals. Exports from Mangolia are wool, animal skins, woollen cloth and woollen knitwear.

In December 1967, India, U.A.R. and Yugoslavia signed a tariff agreement providing for concessions by way of 50 per cent reduction in custom duties on a wide range of products (engineering goods, chemicals and cables etc.) of export interest to three countries and enforceable in the two stages over 1968-69. The concessions could be extended to all other developing nations on a mutual basis. Goods are eligible for concessions if "they are of the origin of the exporting participating state" and if they have been consigned to the territory of the importing state from that of the other state.

In 1968, India and Cameroons signed an agreement for reciprocal extension of most favoured nature in matters of trade and tariffs. This was India's first agreement with a West African country. Similar extension of most favoured nation treatment was extended to Brazil by India by a trade agreement in 1968. Similar agreement could be extended with other countries.

India can look forward to increased trade with Brazil. Earlier India exported lac, carnauba wax and oils to Brazil. In 1966 India imported rice from Brazil and exported telephone equipment in addition to lac. India exported goods worth about Rs. 35 lakhs and imported goods worth 106 lakhs in 1967. India can easily supply machinery, railway vehicles, appliances, which Brazil imports from other countries. She can increase her import of coffee, raw hides and skins, and raw cotton. Capital investment in Brazil is a bright possibility.

Indian Trade with Socialist Block

India has concluded several agreements with the socialist block. Bilateral agreements establish a general method of financing trade between two countries by providing credits available for use in making payments over a wide range of imports from the other country for a definite purpose. Basically, they involve barter transactions without foreign exchange remittances. The main ingredient of the Communist foreign trade system is one-to-one bilateralism. The salient features of India's agreements with Socialist Block may be summarized thus :

(1) The unit of account for settlement of trade balance is the Indian Rupee linked to an exchange rate provision and in most instances with a gold parity clause. It is this safeguard against exchange revaluation.

that delayed the growth of exports after devaluation of the rupee until a satisfactory solution was arrived at. The exchange rate stipulation serves in converting invoice values into currency of account value for settlement. If, however, a single currency is used for all transactions and valuation such a stipulation may be superfluous.

(b) Most of the agreements are for the duration of three years and with annual reviews.

(c) The aggregate trade value targets over the period together with list of items for export/import are stipulated, incorporating special credits and loans as necessary with repayment provisions.

(d) Earlier agreements stipulated that accounts had to be settled by the Exchange Settlement Method. In other words, the rupee had to be converted into a freely convertible currency like the sterling before settlement of balances was affected. This meant that the currency of East European countries was no softer than sterling for India with no inducement on the Indian side to discriminate in favour of imports from these nations. In 1959, the pattern was changed. The rupee balances held by the State Bank of East European countries in India can no longer be converted into sterling and outstanding balances are settled by further exports/imports or by mutual discussions. Thus the off set settlement mechanism has supplanted the exchange settlement in recent agreements and genuine desire for bilateralism has been attained.

70 per cent of exports from the socialist block consist of industrial commodities—complete plants, equipment and machinery and chemicals. India exports to the Soviet Union amounted to 172 million roubles in 1966 and the share of manufactured and semi-manufactured goods reached 43 per cent against 12 per cent in 1956. Besides traditional commodities, India exports steel structures, railway wagons, shoes and chemicals to the Soviet Union and imports from her crude oil, industrial plants, equipment for earth moving, power generating, oil drilling etc. Woollen goods and shoes are finding increasing popularity in Soviet Union.

Indo-Yugoslav trade is governed by a payments agreement that imports and exports will match. Each country has granted to the other most favoured nation treatment. In 1967 India accounted for 2.3 per cent of Yugoslav exports and 1.4 per cent of her imports.

Prospects and Problems of Indo-Socialist Block Trade

Indian exports of traditional items have grown in absolute but not in marginal terms. The real gains have been registered in the field of manufactured and semi-manufactured goods, shoes, fans, etc.

The heavy vehicle industry and the railway wagon industry have received substantial orders from the Socialist Block countries. Indian cutting tools, sewing machines, refrigerators, electric fans and other engineering goods are becoming gradually popular in the East European Market. Trade with the COMECON countries went hand in hand with

aid. Exports agreed upon in advance provided a method to the LDC by which short and medium term credits could be repaid. This was at a time when India needed capital goods procured in return for traditional exports.

The position changed radically in 1968. A number of credits were not utilised by India such as Polish credit for Rs. 40 crores advanced for the manufacture of mining machinery and thermal power equipment, when demand suffered a considerable recession. Domestic capacity has improved. Indian requirements will be in the nature of maintenance imports rather than capital goods. The rate of growth of maintenance imports has been greater than that of capital goods, although absolute volume of the latter has shown an increase. The trend will be towards further diversification as India's need of capital imports has started declining.

- Q.** Trade operates (as a rule) with a fundamental bias in favour of the richer and progressive regions (or countries) and in dis-favour of the less developed countries." —Myrdal. Discuss. Or "The developing countries are faced with the prospect of secular deterioration in the terms of trade." Do you agree with the above view ?

Ans. The Terms Of Trade For The LDC

Normally, the terms of trade" refer to "commodity terms of trade" or the "net barter terms of trade". This refers to the ratio between the prices of two commodities or two groups of commodities exchanged for each other in trade. The price index for exports is divided by the price index for relevant imports.

A rise in the terms of trade and a fall in the terms of trade may not lead respectively to a position of advantage and disadvantage for a number of reasons :

First, the weighted average of prices of exports and imports may not be accurate and unbiased because of changing factor intensities and qualities. Second, a fall in commodity terms of trade is advantageous provided the fall in the unit exprices lead to increased volume of exports. Thirdly, if the fall in unit export is caused by increased productivity, internal factor earnings are likely to rise and country's economic welfare is likely to be enhanced. Fourthly, duties, quotas, transportation costs, price differentials due to exchange controls and the like impose distortions not evident from terms of trade statistics. Remittances abroad by foreigners can offset any export earnings. Finally, the under-invoicing of exports and over-invoicing of imports more prevalent in the less developed countries (LDC) distorts the terms of trade downwards from the true value both in absolute and relative terms to the terms of trade of developed countries.

A group of prominent economists believe that the commodity terms

of trade have deteriorated rather than improved for the poor countries in the long run. Gunnar Myrdal, Hans Singer and Raul Prebisch are the foremost exponents of these views.

Gunnar Myrdal

"Trade operates (as a rule) with a fundamental bias in favour of the richer and progressive regions (and countries) and in disfavour of the less developed countries...harmony of interests must be a very convenient idea for those who have drawn a lucky prize in the lottery of life." Gunnar Myrdal finds the explanation in the circular constellation of forces causing a low income equilibrium. Economic development results in a cumulative causation process whereby the well endowed are awarded more favours and efforts of those who lag behind are thwarted. The backwash effects predominate ; the 'spread' effects are dampened.

Myrdal's arguments against trade as an engine of growth are based on low price and income elasticities of demand for primary exports. The catalytic effect of trade on the economy has been negligible. The Myrdal thesis assumes that technical progress has been greater in industry than in primary production in the face of a slowly growing demand. A higher proportion of the economically active population is employed in low productivity agriculture. Population exerts a constant pressure on real wages which cannot rise in direct proportion to productivity as the latter improves with technological growth. Thus, the increase in income generated by higher agricultural productivity shifts to other parts of the domestic market abroad. In developed societies, the shortage of labour and strong trade unions allow wages to rise with or even outstrip productivity. Hence, the gains from increased productivity are distributed in the form of higher wages and profits rather than lower prices. For raw material the converse applies ; the gains in productivity have taken the form of price reduction.

Myrdal then extends the infant industry argument of the growth of a developing economy and prescribes protectionism as a policy measure to permit domestic market growth, a higher rate of growth of employment, external economies and a non-discriminatory price structure. The Nurkse-Seare thesis of the demonstration effect raising consumer demand and standards of living is assailed on the ground that savings will be inhibited.

Hans Singer

Singer's explanation of the worsening terms of trade of the LDC bears a close resemblance of the Marxist concept of colonial exploitation when he says, "The industrial countries have had the best of both worlds, both as consumers of primary commodities and as producers of manufactured articles. In the richer countries labour markets are monopolistic. With technical progress money incomes rise. The market for exports from the Less Developed Countries (LDC) is price and income inelastic. The real cost of imports for the rich nations is lowered. Foreign investment has created certain dualism in the colonial economies. Hence

activities that cause dynamic radiation of economic activity have not had sufficient impetus.

Raul Prebisch

The powerful supporter of the Less Developing Countries, Raul Prebisch, Secretary General of UNCTAD, attacked the Victorian doctrine that international trade based on the theory of comparative advantage and division of labour would benefit all countries. The periphery (poor) always lost out to the centre (rich countries) as the rates of growth and the import coefficients of the latter were "exogenous" factors.

The decline in two terms of trade of the "periphery" (Less Developed Countries) relative to the centre (rich nations) is due to :

- (i) The Singer effect
- (ii) the fact that in the downswing of the cycle the decline was greater than on the upswing.
- (iii) a greater income elasticity of demand for imports
- (iv) The Myrdal effect productivity increases in the subsistence primary export sector are channelled abroad in the shape of lower prices in a competitive market.

Industrialisation and import substitution do not constitute the panacea. The markets of the rich nations must be thrown open to all categories of exports from the Less Developed Countries. Protectionist policies by the LDC themselves, will not suffice.

All supporters of the secular deterioration hypothesis, adduce further reasons for their findings :

(i) The export proceeds of most under-developed countries are unstable. This instability is caused both by sharp cyclical price fluctuations and long-run secular price decline. Although manufacturing prices have risen less in the upswing they have not fallen as far in depression as they rose during a boom because of the inflexibility of industrial wages and prices in the oligopolistic markets. Between 1900 and 1950 the average annual fluctuation in the prices of 50 commodities was 14 per cent. The volume of demand also fluctuates considerably during the business cycle. Wallich, quoting U.N. data, points out that the volume of exports has a stronger influence than price fluctuations. The whole process of growth is decelerated by the continuous effect of the fall in unit prices which reduces the small surplus left for enlarged reproduction. Any drop in foreign income reduces the imports of capital goods and hence the investment dependent upon them.

(ii) The operation of the Engles Law has been a substantial factor. Economical input-output ratios, the growth of technology and greater substitution among factor inputs have all led to a decline in the unit volume of raw materials required per unit of finished output. With the

exception of petroleum, 40 per cent of exports from the developing countries compete with synthetics. Often factor returns are static and the benefit of any increased productivity goes to the richer country in the shape of lower prices. If raw material prices were artificially raised, even with the consent of the importing countries, economic facts are quickly reversed. Substitution by synthetics is speeded up. Once substitution is in full swing, it is irreversible. Exports fall not merely in volume but even more in value. The net effect of development on the poor country from the consumption side is export biased (pro-trade biased) whereas in the rich country it is import biased (anti-trade biased).

(iii) With a satiated market for tropical products, demand responses to changes in income and retail prices are negligible. Distribution, trade mark up, and processing costs account for the bulk of retail costs. Studies of traditionate imports in the developed countries reveal that not imports rose proportionately with consumption. However, import unit values fell and the total rise in values of imports was marginal. A shift of demand items with high to those with a low import content is evident.

There have been severe criticism of the above doctrine. Firstly, it failed to take account of transport costs. If it is taken into account, this secular decline in the terms of trade is less unfavourable. Secondly, computations of the net barter term of trade have omitted invisibles. Thirdly, the methods of constructing price indexes do not adequately allow for improvements in the quality of old products or introduction of new products. An upward bias to price indexes is thus imported. Since these are more common in the developed countries, the price index for manufactures has a strong upward bias relatively to that for primary products. Kindleberger constructed detailed price indexes for manufactures and primary products. He found that indexes did not show a general shift against primary producers. On the other hand, if it were possible to define units of equality for both group of products, the terms of trade might have worsened for manufactures.

However, where the terms of trade have worsened for primary products, Kindleberge offers a different explanation. If manufactures and primary products have the same productivity growth, Engles Law and the tendency for incremental raw material input contents to fall per unit of end-product causes the demand for manufactures to rise relatively to primary products and thus cause a worsening of the terms of trade for the latter. Given these demand conditions the affluent countries have a further advantage on the supply side. They can reallocate resources where demand is rising away from sectors where demand is falling. The Less Developed Countries are unable to shift resources out of primary products subject to falling demand; prices fall drastically with downward demand trends. Supply elasticities are also assymetrical because supply is elastic to price increase but inelastic to price decreases. Primary products and plantation industries have long gestation periods and life cycles. On the side of entry one gets successive waves of excess capacity from precious booms. Exit is slower and more expensive than entry in the absence of

alternative investment opportunities, an argument also applicable to the extractive industries. Kindleberger concludes that in the developed countries entry and exit are easy for manufactures and primary products; in the developing world entry is easy for primary producers but exit is difficult, while entry is relatively difficult for manufactures of relatively complete products.

He further finds that exports of the LDC face more inelastic foreign demand than the exports of the developed countries because the former are more specialised in their production ranges. Apart from low foreign elasticity of demand, the elasticity of supply is also low. Any domestic supply in the importing country may be highly elastic for price rises, thus restricting the rise in the price of imports. During a period of falling prices, however, import regulations prevent a fall in domestic supply.

Haberler in his "Terms of Trade and Economic Development in Economic Development for Latin America" criticizes the validity of the assumption that the monopoly of factor supplies (specially labour) in the rich nation mean that the terms of trade of the LDC will deteriorate. Monopoly at the factor level will not affect the terms of trade unless there is a monopoly of the product in the world market. Internal wage and price policies will not reflect in the terms of trade where international demand and supply are elastic, unless the exporters possess a monopoly in the world markets. In the world export markets there is substantial price and quality competition among firms exporting capital goods and technology. Countries are warned about their balance of payments and whether their exports are being priced out of the world market. Monopolists in certain countries face competition from producers over-seas. Even the existence of world monopoly does not necessarily indicate a long term trend against the poorer nations; perhaps at the beginning and end of any period it would be less favourable than optimum. It is only if degree of monopoly power changes during the period of the study that the trends in the terms of trade will be affected.

The Prebischian analysis does not tell us why the downward pressure on wages in the LDC, that accounts for the terms of trade decline, cannot be offset by channelling surplus labour into construction and other industries that require no protection.

If labour supply is infinitely elastic for the rural sector at constant wages in terms of wage goods or money, then the control of population is the only possible way out of the trap. Money and real wages are not clearly demarcated. If the shift from agriculture to industry is slow, a wage 'gap' between the rural and Urban Sector is indicated and agricultural prices, before the shift is completed, would be relatively less. However, lower agricultural prices are feasible only when the rural sector has a faster rate of growth of productivity. It is the wage gap that determines the equivalent payment due to rural producers if rural urban wage incomes are to be at parity.

Even if the income elasticity of demand for agricultural products is

less than unity, it is the overall expansion of demand for exports that counts. The absolute demand from the richer countries may still grow with development. The supply of domestic output of imports may become inelastic and necessitate larger imports.

The entire analysis rests on the commodity term of trade. Exports as well as productivity in the export sector have been enhanced. This means that the single factoral and income terms of trade can be favourable even with adverse commodity terms of trade. The double factoral terms of trade may deteriorate. But the poorer countries receive more imports per unit of exported factors and this has a positive welfare effect.

Evaluation

It is quite true that tariff and non-tariff barriers in industrial countries to restrict the access to these markets of the products of the LDC. But the policies-internal and fiscal policies of the LDC and the consequent reforms are less emphasised. These do result in inhibiting the export potential of developing countries.

Contrary to the pure theory of comparative advantage, export maximum of LDC is determined by the fact that overseas demand could be restricted or that where demand does exist, domestic supplies are inelastic. Exports become a lagging rather than a leading sector. Nor is the general level of absolute productivity high enough in most instances to produce a sufficient quantity of what is demanded abroad.

The process of economic development results inevitably in an increase in the absolute value of input and capital imports with the LDC. The actual and potential foreign exchange gap has grown. The rate of growth in the price of capital goods and maintenance imports has been greater than the increase in the unit values of the traditional exports. Thus the great gap has developed.

INDIAN DEFENCE EXPENDITURES AND PAYMENTS PROBLEM

Q. How did the defence imports accentuate the balance of payments problems. *Or*

Examine the justification for a policy of self-sufficiency in defence production pursued by India after 1962.

Ans. During 1967, as a result of the strains in the Indian economy from the famine of 1965-6 and of the cessation of U.S. aid following the Indo-Pakistan War of 1965, it was suggested that the level of Indian defence expenditure might be reduced. It was expected that stringent economic conditions justified a part of Rs. 1000 crores annual outlay to economic development. However, the recent war with Pakistan in 1971 has justified the necessity of spending substantial amount of expenditure on defence needs. Not simply that, being a big country and a country with a future, India has to maintain substantial military, air and naval strength in order to secure herself against potential and actual threats and also in order to carry out certain necessary commitments. India has no choice in matter of defence expenditure. There are no eternal friends or eternal enemies in the comity of nations. She has to be prepared for a possible combination of two powers against her. Because she is bounded by China and Pakistan and because she has a large sea coast line, India, inevitably spends money to keep her secure.

India's yearly defence expenditure was below Rs. 200 crores throughout the fifties. It was 1.8 percent of the national income in 1950, 1.9 percent in 1955, 2 percent in 1960, and 2.1 percent in 1961. This was in spite of the fact that Pakistan, whose army at the time of partition was about a third of the size of the Indian army, entered with military alliances, expanded its armed forces to reach 70 percent of the strength of Indian armed forces, and had a steady inflow of armies technologically superior to India's. Pakistan was spending about 3.7 percent of a much smaller G.N.P. on defence in 1950, 4.1 percent in 1955, 4.3 percent in 1960. India did not enter with an arms race. But India was roused from slumber by an unexpected aggression from China.

The Chinese attack in 1962 clarified for India her geographic reality. She had to be alive to face an active threat by China and Pakistan. She could definitely depend upon the fact that Americans and Russians would look with disfavour upon Chinese adventure. Earlier to 1962, she did depend upon this, but 'truth is stronger than fiction' and the 1962 pair-pointed the fact that diplomacy was no substitute for military strength.

India has been compelled to resort to antarcctic policies in its defence production for political, economic and strategic consideration. India was warned by events in 1965 that reliance on foreign sources of supply can seriously hamper its defence effort by stoppage of spare parts and components at the crucial moment. Understandly India did not want to undergo such an experience again. The recent war in 1971 confirmed the suspicion and the consequent policy implications. Besides, arms market is not a free market and supply of arms is dictated by political consideration. In the supply of sophisticated weapons system there is a noticable resistance on the part of the established supplier countries to part with sophisticated system unless the armed forces of the recipient country are integrated with their own command, control and logistic system, and the supplier countries are confident of the influence they have on the armed forces of the recipient countries. To-day's complexes of weapons systems are highly specialised to meet the needs and likely wars of the countries concerned. India has its own highly specialised type of operation to support ; two fronts, high altitudes, long borders, non-alignment, and graduated response. So it must develop an inter-related and integrated weapons—and equipment system complex which will meet those requirements. No single supplies can meet her requirements. Besides the size of her armed forces is quite substantial. Hence imports on a large scale are unjustified on economic grounds. It is cheaper to produce locally, in view of the economies of scale. The arms factories exist in India already, its balance of payments is a powerful argument for rapid import substitution in this sector.

India has been compelled to spend considerable amounts on submarines, frigates etc. because of the possibilities of intervention by big powers. Similarly expenditure on sophisticated air-craft system was justified because Pakistan introduced such system in her defence system. Although the necessary foreign exchange seemed less feasible, still the security needs did predominate.

It has been estimated that in 1965-6, 11 percent of the expenditure was on defence in foreign exchange. Since then there has been intensive drive towards self sufficiency and self reliance. India was spending about Rs. 45 to 46 crores in foreign exchange for defence even before Oct. 1962. The likely expenditure in foreign exchange will be not less than Rs. 60 crores. But in view of the fact that Indian manufactured equipment is replacing foreign equipment more and more, and is able to rely more on the supply of local plants and machinery, the foreign exchange requirement will lessen in future. India may try to distribute the burden of payments by seeking long term credits from supplying countries. The additional burden on

its balance of payments will depend on its success in getting long term credits for its defence supplies. India's continued non-alignment will make a wide range of markets accessible and is thus likely to prove an asset.

To conclude, this recent war with Pakistan has justified the big jump in defence expenditure. The big reversal point came in 1962 when India realized that diplomacy was no substitute for defence preparedness. Her geographic location and the state of preparedness of her neighbours and especially the uncertainty of their attitude towards India has justified the emergence of sophisticated defence system despite her poverty. She had to import under duress. Now she can try for liberal terms and can concentrate on rapid import substitution of the items which had to be imported. She does not have a choice. At last she can opt for import substitution so far it is feasible.



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